Office of the Comptroller of the Currency
June 1999

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Background

The Office of the Comptroller of the Currency (OCC) was established in 1863 as a bureau of the Department of the Treasury. The OCC is headed by the Comptroller, who is appointed by the President, with the advice and consent of the Senate, for a five-year term.

The OCC regulates national banks by its power to:

- Examine the banks;
- Approve or deny applications for new charters, branches, capital, or other changes in corporate or banking structure;
- Take supervisory actions against banks that do not conform to laws and regulations or that otherwise engage in unsound banking practices, including removal of officers, negotiation of agreements to change existing banking practices, and issuance of cease and desist orders; and
- Issue rules and regulations concerning banking practices and governing bank lending and investment practices and corporate structure.

The OCC divides the United States into six geographical districts, with each headed by a deputy comptroller.

The OCC is funded through assessments on the assets of national banks, and federal branches and agencies. Under the International Banking Act of 1978, the OCC regulates federal branches and agencies of foreign banks in the United States.

The Comptroller

The Comptroller John D. Hawke Jr. was sworn in as the 28th Comptroller of the Currency on December 8, 1998. Prior to his appointment Mr. Hawke served for 3½ years as Under Secretary of the Treasury for Domestic Finance. He oversaw development of policy and legislation on financial institutions, debt management, and capital markets; served as chairman of the Advanced Counterfeit Deterrence Steering Committee; and was a member of the board of the Securities Investor Protection Corporation. Before joining Treasury, he was a senior partner at the Washington, D.C. law firm of Arnold & Porter, which he joined as an associate in 1962. In 1975 he left to serve as general counsel to the Board of Governors of the Federal Reserve System, returning in 1978. At Arnold & Porter he headed the financial institutions practice. From 1987 to 1995 he was chairman of the firm.

Mr. Hawke has written extensively on the regulation of financial institutions, including *Commentaries on Banking Regulation,* published in 1985. From 1970 to 1987 he taught courses on federal regulation of banking at Georgetown University Law Center. He has also taught courses on bank acquisitions and serves as chairman of the Board of Advisors of the Morin Center for Banking Law Studies. In 1987 Mr. Hawke served on a committee of inquiry appointed by the Chicago Mercantile Exchange to study the role of futures markets in the October 1987 stock market crash. He was a founding member of the Shadow Financial Regulatory Committee, and served on it until joining Treasury.

Mr. Hawke was graduated from Yale University in 1954 with a B.A. in English. From 1955 to 1957 he served on active duty with the U.S. Air Force. After graduating in 1960 from Columbia University School of Law, where he was editor-in-chief of the *Columbia Law Review,* Mr. Hawke clerked for Judge E. Barrett Prettyman on the U.S. Court of Appeals for the District of Columbia Circuit. From 1961 to 1962 he was counsel to the Select Subcommittee on Education, U.S. House of Representatives.

The *Quarterly Journal* is the journal of record for the most significant actions and policies of the Office of the Comptroller of the Currency. It is published four times a year. The *Quarterly Journal* includes policy statements, decisions on banking structure, selected speeches and congressional testimony, material released in the interpretive letters series, statistical data, and other information of interest to the administration of national banks. Send suggestions or questions to Rebecca Miller, Senior Writer-Editor, Communications Division, Comptroller of the Currency, Washington, DC 20219. Subscriptions are available for $100 a year by writing to Publications—QJ, Comptroller of the Currency, P.O. Box 70004, Chicago, IL 60673–0004. The *Quarterly Journal* is on the Web at http://www.occ.treas.gov/qj/qj.htm.

Quarterly Journal

Office of the Comptroller of the Currency

John D. Hawke Jr.

Comptroller of the Currency

The Administrator of National Banks

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Condition and Performance of Commercial Banks

Summary

The commercial banking industry reported record earnings in the first quarter 1999 of $18 billion, following two quarters of earnings declines. The $2 billion increase in net income from a year ago was due primarily to growth in non-interest income, particularly in large banks, with trading revenue being the fastest-growing component.

By many traditional measures, the first quarter results were positive for the banking industry. Return on equity and return on assets were at or near recent highs, and credit losses overall were low. Equity-to-asset ratios continued to improve.

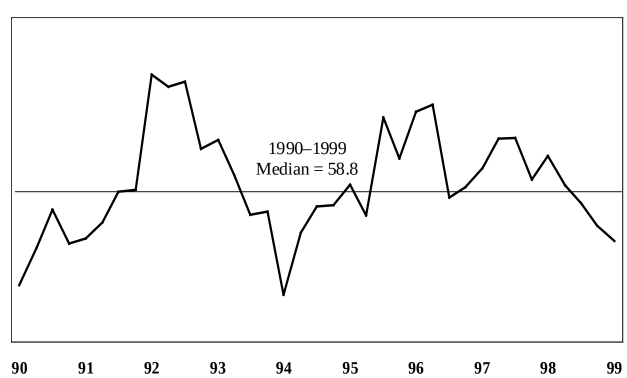
At the same time, not all the news was positive. A significant percentage of banks, especially smaller banks, did not participate in the growth in profitability. Delinquencies for some loan categories moved upward, supporting concerns about credit quality. Interest margins continued to fall, reaching the lowest level since the fourth quarter of 1990. Questions persisted about the industry's level of exposure to year-2000 problems.

The unfavorable news regarding first quarter results underscored concerns about the sustainability of industry earnings, concerns reflected in recent declines in the stock markets' valuations of certain banks. At the end of May, the Philadelphia Stock Exchange/KBW Bank Index closed below the closing level at the end of March, despite the strong first quarter performance by larger banks, whose performance the stock price index reflects.

Uneven Earnings Distribution

The strong earnings for the industry as a whole obscured weakening profitability for a large portion of the industry. The industry's median ROA actually fell to 1.11 percent compared to 1.14 in 1998 and 1.19 in 1997. As shown in Figure 1, the percentage of banks reporting earnings gains has been declining for the past four quarters. Only 52 percent of banks reported earnings gains in the first quarter, compared with 63 percent in the first quarter 1998 and 61 percent in the first quarter 1997.

Figure 1—Banks reporting earnings gains (commercial banks)



* All data as of quarter-end.
Source: Integrated Banking Information System

The contrast in earnings performance was particularly strong between smaller and larger banks. As shown in Table 1, ROE and ROA decreased year-to-year for banks with less than $10 billion in assets. Return on equity decreased 98 basis points for banks with less than $100 million in assets, and 65 basis points for banks with assets between $100 million and $1 billion. In contrast, banks with greater than $10 billion in assets had a 105 basis point gain in ROE and 13 basis point gain in ROA.

Table 1—Changes in commercial bank return on equity and return on assets, first quarter 1998 to first quarter 1999, by asset size

	Basis point change	
Bank asset size	ROE	ROA
Less than $100 million	–98	–9
$100 million to $1 billion	–65	–7
$1 billion to $10 billion	–52	–1
Greater than $10 billion	+105	+13

Other measures indicate that smaller banks did less well in the first quarter than larger banks. One bank out of every 11 banks with under $100 million in assets was unprofitable, while only one bank out of the 73 banks with greater than $10 billion in assets was unprofitable. Over half of the banks with less than $100 million in assets reported a decline in earnings in the first quarter, while slightly more than one quarter of banks with greater than $10 billion in assets had earnings declines.

Emerging Credit Risk

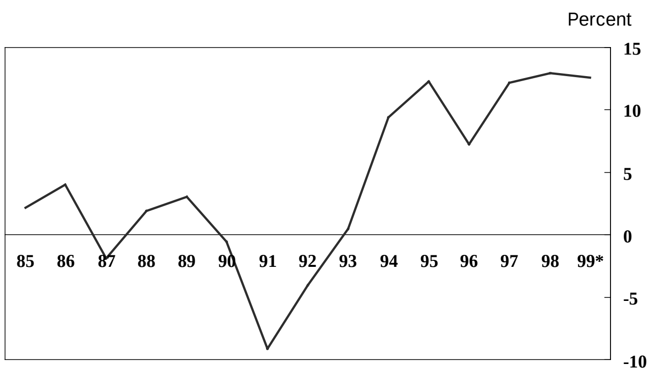
First quarter results reflected strong loan quality for the industry overall. Loan delinquencies overall, including loans past due 30–89 days and noncurrent loans, remained near historic lows.

Despite the good news, some areas of credit deterioration continued to emerge. Noncurrent loans in dollar terms have increased in four of the past five quarters after steady declines since the first quarter of 1991. This increase reinforces the concerns that bank regulators have expressed regarding weakening loan underwriting standards.

Additionally, banks have increased their loan portfolios in loan categories where greater credit risk is emerging.

- *Commercial and industrial loans.* As shown in Figure 2, commercial banks have been increasing their portfolios of commercial and industrial (C&I) loans at a 12–13 percent annual rate since 1996. Commercial and industrial loans now exceed 28 percent as a percentage of all loans in portfolio.

Figure 2—Growth rates of commercial and industrial loan portfolios (commercial banks)



*1999 data as of March 31, 1999. All other data as of year-end.
Source: Integrated Banking Information System

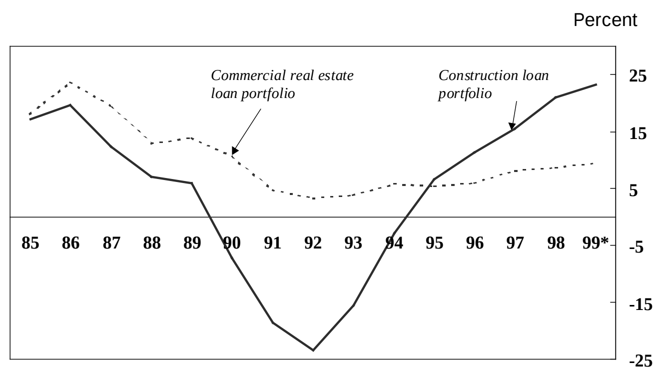
As shown in Figure 3, the delinquency rate for C&I loans has increased recently. The C&I loan delinquency rate rose during each of the three most recent quarters, although still near the low end of the 1.7 to 7.1 percent range experienced since 1984. Commercial and industrial loan delinquency exceeded 2 percent of total C&I loans in the first quarter for the first time in two years. The increase is due in part to the impact of the global economic slowdown on the U.S. manufacturing sector.

Figure 3—Delinquency rate on commercial and industrial loans (commercial banks)

*All data as of quarter-end.
Source: Integrated Banking Information System

- *Construction and commercial real estate loans*. As shown in Figure 4, banks have been increasing their portfolios of construction and commercial real estate loans at accelerating rates. Construction loan portfolios grew at annual rates above 20 percent in recent quarters. Commercial real estate loan portfolios have also been growing at a quickening pace.

Figure 4—Growth rates of construction and commercial real estate loan portfolios (commercial banks)



*1999 data as of March 31, 1999. All other data as of year-end.
Source: Integrated Banking Information System

The growth rates in commercial real estate and construction lending portfolios are of concern because of new signs of rising vacancy rates. While still at a low level and affecting only selected markets, the U.S. national office vacancy rate rose in the first quarter for the first time since 1992. In the Northeast, the office vacancy rate in Boston rose to 11.9 percent, and in Hartford to 18 percent. In Texas, the office vacancy rate in Dallas rose to 17.7 percent, and in Ft. Worth to 15.9 percent.

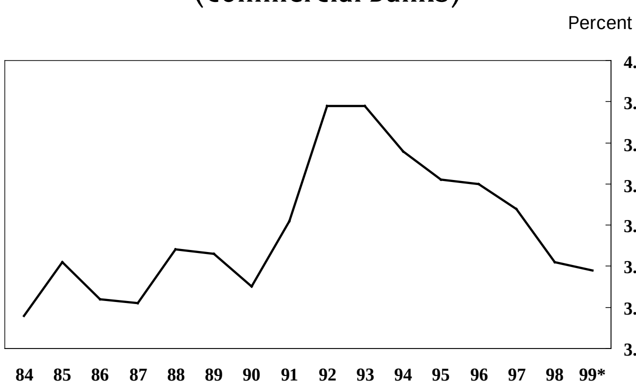
- *Consumer loans*. Banks have been reducing their level of consumer loans in portfolio, and delinquency rates on consumer loans have fallen in recent quarters from high levels. In contrast to this generally improving trend, however, banks in the Midwest and Southwest regions experienced an increase in delinquent consumer real estate loans. This experience reflects in part continuing financial difficulty associated with low commodity prices and bad weather in agricultural regions.

As the economy continued to expand strongly, consumer credit continued to expand at a very fast pace. One study (*Regional Outlook,* Second Quarter 1999, Federal Deposit Insurance Corporation) suggested that new extensions of consumer credit have been characterized by less creditworthy borrowers, some relaxation of collateral requirements, and increasing levels of riskier high loan-to-value home equity loans.

Vulnerabilities to Higher Interest Rates

The ratio of net interest income to assets, or net interest margin, reached 3.49 percent in the first quarter 1999, its lowest level since 1990 (see Figure 5). Net interest margin continued to shrink for all bank asset-size categories except banks with greater than $10 billion in assets.

Figure 5—Net interest income to assets (commercial banks)

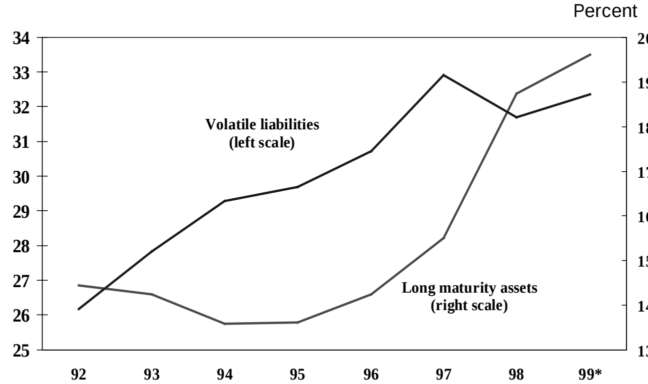


*1999 data as of March 31, 1999. All other data as of year-end.
Source: Integrated Banking Information System

As net interest margin has fallen, larger banks have sought to rebuild their net interest margins by lengthening the average maturity of their assets. As shown in Figure 6, the percentage of bank assets with maturities over 5 years has grown from about 14 percent in the fourth quarter 1996 to nearly 20 percent in the first quarter of 1999. For banks with $1–10 billion in assets, longer maturity assets grew to over 21 percent of assets in the first quarter of 1999.

At the same time, also as shown in Figure 6, banks have increasingly relied on liabilities whose costs are volatile. In a rising interest rate environment, the increasing proportions of longer maturity assets and volatile liabilities raise interest rate risk.

Figure 6—Long maturity assets and volatile liabilities to total assets (commercial banks)



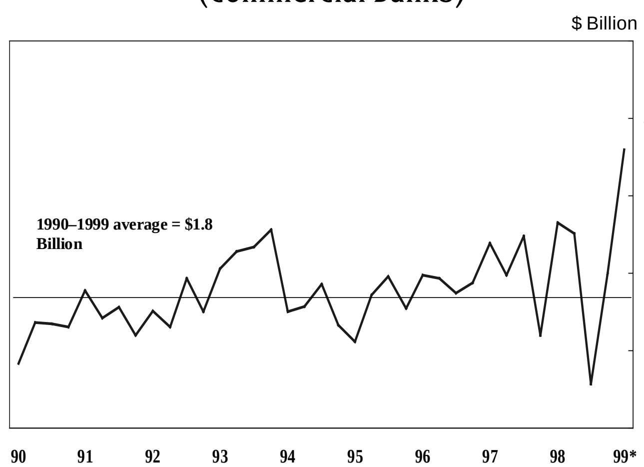
*1999 data as of March 31, 1999. All other data as of year-end.
Source: Integrated Banking Information System

Increasingly Volatile Trading Revenue

The industry's first quarter increased profitability resulted principally from a 19 percent increase in non-interest income (on a year-over-year basis). Trading revenue represented the fastest growing component of the increase in non-interest income, increasing by over 35 percent. The first quarter sharp upswing in trading revenue contributed an estimated 3 basis points to ROA.

As shown in Figure 7, however, trading revenue has become increasingly volatile recently. Trading revenue grew sharply in the first quarter to $3.5 billion, rebounding from its depressed level in the third quarter of 1998 when international markets were in turmoil.

Figure 7—Quarterly trading revenue (commercial banks)



*All data as of quarter-end. 1999 data is annualized.
Source: Integrated Banking Information System

Conclusion: Sustainability of Industry Profitability

The first quarter record results for the banking industry reflected a number of trends in sources of industry profits.

- Non-interest income grew nearly 20 percent, continuing a trend in which non-interest income has become an increasingly large source of bank revenue.
- Loan provisioning continued at historically low levels.
- Net interest margins declined only slightly.

The ability of the industry to sustain and exceed the record earnings of the first quarter of 1999 will depend on its ability to sustain these trends, which may become increasingly difficult. The changing maturity composition of commercial bank balance sheets means that net interest income may be difficult to sustain even at the current low level, certainly if interest rates rise. The changing composition of loan portfolios and loan terms and conditions means that loan provisions may be difficult to sustain at low levels in the future, certainly if the economy weakens. Recent volatility in trading revenue highlights its unstable contribution to bank income.

Key indicators, FDIC-insured national banks
Annual 1995–1998, year-to-date through March 31, 1999, first quarter 1998, and first quarter 1999
(Dollar figures in millions)

	1995	1996	1997	1998	Preliminary 1999YTD	1997Q1	Preliminary 1998Q1
Number of institutions reporting	2,858	2,726	2,597	2,456	2,432	2,549	2,432
Total employees (FTEs)	840,699	850,737	912,463	974,868	962,917	929,003	962,917
Selected income data ($)							
Net income	$28,583	$30,497	$35,782	$37,629	$10,535	$9,984	$10,535
Net interest income	87,080	94,564	106,641	110,986	28,665	26,887	28,665
Provision for loan losses	6,335	9,598	13,065	15,230	4,080	3,182	4,080
Noninterest income	51,080	56,100	65,428	81,348	22,550	18,301	22,550
Noninterest expense	87,591	93,690	104,683	122,587	31,166	27,933	31,166
Net operating income	28,540	30,095	34,993	35,569	10,315	9,047	10,315
Cash dividends declared	20,516	25,279	28,587	25,411	5,180	7,666	5,180
Net charge-offs to loan and lease reserve	6,459	9,968	12,661	14,480	3,691	3,185	3,691
Selected condition data ($)							
Total assets	2,401,017	2,528,057	2,893,910	3,183,338	3,141,344	2,972,012	3,141,344
Total loans and leases	1,522,677	1,641,464	1,840,510	2,015,629	2,016,799	1,880,747	2,016,799
Reserve for losses	31,142	31,992	34,865	36,809	37,266	35,303	37,266
Securities	390,549	380,615	452,118	516,084	527,414	479,681	527,414
Other real estate owned	3,396	2,761	2,112	1,833	1,824	2,061	1,824
Noncurrent loans and leases	17,595	17,223	17,878	19,508	20,244	18,276	20,244
Total deposits	1,695,817	1,801,043	2,004,867	2,137,948	2,101,359	2,032,088	2,101,359
Domestic deposits	1,406,312	1,525,565	1,685,316	1,785,859	1,747,066	1,715,979	1,747,066
Equity capital	189,714	207,166	244,795	274,217	278,731	253,566	278,731
Off-balance-sheet derivatives	7,914,818	7,488,663	8,704,481	10,947,916	10,720,818	9,003,559	10,720,818
Performance ratios (annualized %)							
Return on equity	15.76	15.28	15.00	14.30	15.25	15.99	15.25
Return on assets	1.24	1.25	1.29	1.24	1.33	1.36	1.33
Net interest income to assets	3.78	3.88	3.83	3.67	3.63	3.66	3.63
Loss provision to assets	0.27	0.39	0.47	0.50	0.52	0.43	0.52
Net operating income to assets	1.24	1.24	1.26	1.18	1.30	1.23	1.30
Noninterest income to assets	2.22	2.30	2.35	2.69	2.85	2.49	2.85
Noninterest expense to assets	3.80	3.85	3.76	4.05	3.94	3.80	3.94
Loss provision to loans and leases	0.44	0.61	0.73	0.79	0.81	0.68	0.81
Net charge-offs to loans and leases	0.45	0.63	0.71	0.75	0.73	0.68	0.73
Loss provision to net charge-offs	98.09	96.29	103.19	105.13	110.56	99.84	110.56
Performance ratios (%)							
Percent of institutions unprofitable	3.32	4.77	4.89	5.86	5.88	4.67	5.88
Percent of institutions with earnings gains	66.83	67.83	67.96	61.89	53.78	63.36	53.37
Nonint. income to net operating revenue	36.97	37.24	38.02	42.30	44.03	40.50	44.03
Nonint. expense to net operating revenue	63.40	62.18	60.84	63.74	60.85	61.82	60.8
Condition ratios (%)							
Nonperforming assets to assets	0.88	0.80	0.70	0.68	0.71	0.69	0.71
Noncurrent loans to loans	1.16	1.05	0.97	0.97	1.00	0.97	1.00
Loss reserve to noncurrent loans	176.99	185.75	195.01	188.69	184.09	193.17	184.09
Loss reserve to loans	2.05	1.95	1.89	1.83	1.85	1.88	1.85
Equity capital to assets	7.90	8.19	8.46	8.61	8.87	8.53	8.87
Leverage ratio	7.31	7.40	7.42	7.43	7.52	7.39	7.52
Risk-based capital ratio	12.09	11.97	11.86	11.80	12.04	11.99	12.04
Net loans and leases to assets	62.12	63.66	62.39	62.16	63.02	62.09	63.02
Securities to assets	16.27	15.06	15.62	16.21	16.79	16.14	16.79
Appreciation in securities (% of par)	0.86	0.50	1.11	0.82	0.17	1.00	0.17
Residential mortgage assets to assets	20.13	19.81	20.10	20.41	20.06	20.43	20.06
Total deposits to assets	70.63	71.24	69.28	67.16	66.89	68.37	66.89
Core deposits to assets	53.28	54.08	51.59	49.72	49.13	50.88	49.13
Volatile liabilities to assets	30.29	29.83	31.42	31.77	32.18	31.86	32.18

Loan performance, FDIC-insured national banks
Annual 1995–1998, year-to-date through March 31, 1999, first quarter 1998, and first quarter 1999
(Dollar figures in millions)

	1995	1996	1997	1998	Preliminary 1999YTD	1998Q1	Preliminary 1999Q1
Percent of loans past due 30–89 days							
Total loans and leases	1.26	1.39	1.32	1.27	1.19	1.26	1.19
Loans secured by real estate (RE)	1.38	1.45	1.39	1.33	1.17	1.30	1.17
1–4 family residential mortgages	1.44	1.63	1.65	1.50	1.20	1.45	1.20
Home equity loans	1.19	1.04	0.93	0.97	0.75	0.83	0.75
Multifamily residential mortgages	1.15	1.28	1.33	0.94	1.83	0.97	1.83
Commercial RE loans	1.26	1.25	0.95	1.02	0.98	1.08	0.98
Construction RE loans	1.42	1.63	1.63	1.82	1.63	1.56	1.63
Commercial and industrial loans*	0.77	0.89	0.76	0.81	0.85	0.82	0.85
Loans to individuals	2.16	2.46	2.52	2.44	2.28	2.28	2.28
Credit cards	2.35	2.70	2.75	2.52	2.35	2.57	2.35
Installment loans	2.04	2.26	2.34	2.37	2.22	2.05	2.22
All other loans and leases	0.40	0.41	0.46	0.46	0.57	0.62	0.57
Percent of loans noncurrent							
Total loans and leases	1.16	1.05	0.97	0.97	1.00	0.97	1.00
Loans secured by real estate (RE)	1.46	1.27	1.07	0.98	0.93	1.04	0.93
1–4 family residential mortgages	0.90	1.10	1.01	0.95	0.83	0.98	0.83
Home equity loans	0.52	0.47	0.43	0.41	0.36	0.43	0.36
Multifamily residential mortgages	2.21	1.47	1.01	0.88	1.21	0.93	1.21
Commercial RE loans	2.18	1.71	1.27	1.01	0.96	1.20	0.96
Construction RE loans	3.17	1.31	1.00	0.80	0.92	1.06	0.92
Commercial and industrial loans*	1.06	0.87	0.78	0.86	1.00	0.88	1.00
Loans to individuals	1.18	1.34	1.49	1.58	1.59	1.43	1.59
Credit cards	1.34	1.70	2.03	2.06	2.08	1.96	2.08
Installment loans	1.06	1.04	1.04	1.18	1.23	1.03	1.23
All other loans and leases	0.32	0.25	0.27	0.31	0.47	0.29	0.47
Percent of loans charged-off, net							
Total loans and leases	0.45	0.63	0.71	0.75	0.73	0.68	0.73
Loans secured by real estate (RE)	0.13	0.09	0.06	0.05	0.07	0.05	0.07
1–4 family residential mortgages	0.10	0.08	0.08	0.07	0.08	0.07	0.08
Home equity loans	0.23	0.24	0.18	0.16	0.20	0.21	0.20
Multifamily residential mortgages	0.20	0.09	0.01	0.07	–0.01	–0.02	–0.01
Commercial RE loans	0.18	0.02	–0.01	–0.02	0.02	–0.02	0.02
Construction RE loans	–0.01	0.16	–0.10	–0.01	0.03	0.00	0.03
Commercial and industrial loans*	0.10	0.22	0.27	0.38	0.45	0.23	0.45
Loans to individuals	1.80	2.45	2.86	2.92	2.89	2.95	2.89
Credit cards	3.40	4.25	4.95	5.02	4.91	5.08	4.91
Installment loans	0.76	1.04	1.20	1.22	1.29	1.27	1.29
All other loans and leases	–0.28	0.34	0.30	1.58	0.26	0.16	0.26
Loans outstanding ($)							
Total loans and leases	$1,522,677	$1,641,464	$1,840,510	$2,015,629	$2,016,799	$1,880,747	$2,016,799
Loans secured by real estate (RE)	610,405	646,570	725,305	764,871	756,914	743,551	756,914
1–4 family residential mortgages	317,521	329,031	363,329	381,525	368,623	374,483	368,623
Home equity loans	48,836	55,022	67,669	66,091	65,167	67,030	65,167
Multifamily residential mortgages	18,161	20,480	23,346	23,201	24,476	23,988	24,476
Commercial RE loans	157,638	170,350	190,067	200,469	202,151	193,840	202,151
Construction RE loans	34,736	38,848	47,410	56,260	59,300	49,460	59,300
Farmland loans	8,734	9,046	10,178	10,930	10,990	10,367	10,990
RE loans from foreign offices	24,779	23,794	23,306	26,396	26,208	24,384	26,208
Commercial and industrial loans	405,630	425,148	508,589	583,930	601,782	528,007	601,782
Loans to individuals	320,009	356,067	371,498	386,472	364,844	358,608	364,844
Credit cards	131,228	161,104	168,257	176,458	157,436	154,281	157,436
Installment loans	188,781	194,963	203,241	210,014	207,408	204,327	207,408
All other loans and leases	189,490	216,194	237,329	282,395	295,180	252,716	295,180
Less: Unearned income	2,857	2,515	2,212	2,039	1,922	2,134	1,922

*Includes "All other loans" for institutions under $1 billion in asset size.

Key indicators, FDIC-insured national banks by asset size
First quarter 1998 and first quarter 1999
(Dollar figures in millions)

	Less than $100M		$100M to $1B		$1B to $10B		Greater than $10B	
	1998Q1	1999Q1	1998Q1	1999Q1	1998Q1	1999Q1	1998Q1	1999Q1
Number of institutions reporting	1,349	1,253	1,016	992	143	143	41	44
Total employees (FTEs)	34,505	31,936	113,603	106,930	154,443	144,280	626,452	679,771
Selected income data ($)								
Net income	$201	$206	$923	$802	$2,343	$2,318	$6,517	$7,209
Net interest income	712	627	2,732	2,583	5,165	4,910	18,278	20,544
Provision for loan losses	36	29	186	211	998	1,017	1,962	2,823
Noninterest income	369	388	1,357	1,264	3,364	5,063	13,211	15,835
Noninterest expense	768	714	2,542	2,478	4,732	5,344	19,891	22,630
Net operating income	199	205	913	794	1,782	2,287	6,153	7,030
Cash dividends declared	198	142	477	539	921	1,134	6,071	3,366
Net charge-offs to loan and lease reserve	19	16	132	142	1,151	909	1,883	2,623
Selected condition data ($)								
Total assets	67,559	62,507	268,585	257,053	475,622	443,664	2,160,247	2,378,121
Total loans and leases	38,641	35,259	161,854	155,096	312,559	287,095	1,367,693	1,539,349
Reserve for losses	535	484	2,362	2,289	7,888	7,048	24,519	27,445
Securities	18,388	17,349	71,461	71,371	93,051	87,815	296,782	350,879
Other real estate owned	94	70	257	242	214	191	1,496	1,321
Noncurrent loans and leases	423	394	1,360	1,370	3,285	2,907	13,207	15,573
Total deposits	58,037	53,320	220,144	210,117	316,698	283,901	1,437,209	1,554,022
Domestic deposits	58,037	53,320	219,650	209,618	311,161	278,434	1,127,131	1,205,695
Equity capital	7,219	6,923	25,681	24,363	47,092	47,206	173,574	200,238
Off-balance-sheet derivatives	557	76	3,728	3,062	67,749	57,978	9,201,905	10,921,611
Performance ratios (annualized %)								
Return on equity	11.16	11.86	14.61	13.23	20.46	19.88	15.20	14.52
Return on assets	1.20	1.32	1.39	1.25	1.97	2.06	1.22	1.21
Net interest income to assets	4.24	4.01	4.11	4.03	4.35	4.36	3.43	3.43
Loss provision to assets	0.21	0.18	0.28	0.33	0.84	0.90	0.37	0.47
Net operating income to assets	1.19	1.31	1.37	1.24	1.50	2.03	1.15	1.18
Noninterest income to assets	2.20	2.48	2.04	1.97	2.83	4.49	2.48	2.65
Noninterest expense to assets	4.57	4.57	3.82	3.86	3.99	4.74	3.73	3.78
Loss provision to loans and leases	0.37	0.33	0.46	0.55	1.27	1.40	0.58	0.74
Net charge-offs to loans and leases	0.19	0.18	0.33	0.37	1.46	1.25	0.56	0.68
Loss provision to net charge-offs	191.17	178.56	141.14	148.27	86.68	111.78	104.08	107.67
Performance ratios (%)								
Percent of institutions unprofitable	7.12	9.42	1.87	1.81	2.10	4.20	2.44	2.27
Percent of institutions with earnings gains	57.45	47.09	69.69	60.28	70.63	58.74	75.61	59.09
Nonint. income to net operating revenue	34.13	38.22	33.19	32.85	39.44	50.76	41.96	43.53
Nonint. expense to net operating revenue	71.03	70.38	62.17	64.40	55.48	53.58	63.17	62.21
Condition ratios (%)								
Nonperforming assets to assets	0.77	0.74	0.60	0.63	0.74	0.70	0.69	0.72
Noncurrent loans to loans	1.10	1.12	0.84	0.88	1.05	1.01	0.97	1.01
Loss reserve to noncurrent loans	126.27	122.78	173.65	167.16	240.10	242.42	185.66	176.24
Loss reserve to loans	1.38	1.37	1.46	1.48	2.52	2.45	1.79	1.78
Equity capital to assets	10.69	11.08	9.56	9.48	9.90	10.64	8.03	8.42
Leverage ratio	10.45	10.74	9.15	9.03	8.61	8.97	6.80	7.00
Risk-based capital ratio	17.91	18.41	15.03	14.90	13.40	14.03	11.27	11.36
Net loans and leases to assets	56.41	55.63	59.38	59.45	64.06	63.12	62.18	63.58
Securities to assets	27.22	27.76	26.61	27.76	19.56	19.79	13.74	14.75
Appreciation in securities (% of par)	0.71	0.41	0.89	0.53	0.98	0.38	1.06	0.03
Residential mortgage assets to assets	22.08	21.68	25.99	25.96	22.69	24.39	19.19	18.58
Total deposits to assets	85.91	85.30	81.96	81.74	66.59	63.99	66.53	65.35
Core deposits to assets	74.78	73.85	70.94	70.09	57.36	54.91	46.22	45.13
Volatile liabilities to assets	12.52	12.80	16.41	16.73	25.94	26.43	35.69	35.44

Loan performance, FDIC-insured national banks by asset size
First quarter 1998 and first quarter 1999
(Dollar figures in millions)

	Less than $100M		$100M to $1B		$1B to $10B		Greater than $10B	
	1998Q1	1999Q1	1998Q1	1999Q1	1998Q1	1999Q1	1998Q1	1999Q1
Percent of loans past due 30–89 days								
Total loans and leases	1.74	1.74	1.35	1.38	1.66	1.54	1.14	1.09
Loans secured by real estate (RE)	1.48	1.44	1.14	1.11	1.24	1.21	1.34	1.16
1–4 family residential mortgages	1.80	1.64	1.30	1.30	1.21	1.10	1.52	1.19
Home equity loans	0.83	0.68	0.88	0.75	0.97	0.86	0.80	0.73
Multifamily residential mortgages	0.70	0.51	0.87	0.80	1.10	0.68	0.97	2.41
Commercial RE loans	1.15	1.12	0.90	0.87	1.15	1.15	1.10	0.95
Construction RE loans	1.14	1.32	1.27	1.24	1.93	2.41	1.54	1.49
Commercial and industrial loans*	3.32	3.51	1.84	1.97	1.34	1.35	0.63	0.70
Loans to individuals	2.17	2.12	1.87	1.96	2.40	2.16	2.27	2.35
Credit cards	2.73	2.07	2.56	3.43	2.54	2.29	2.60	2.34
Installment loans	2.12	2.12	1.72	1.63	2.18	1.96	2.06	2.36
All other loans and leases	na	na	na	na	1.36	1.36	0.56	0.51
Percent of loans noncurrent								
Total loans and leases	1.10	1.12	0.84	0.88	1.05	1.01	0.97	1.01
Loans secured by real estate (RE)	0.92	0.89	0.71	0.69	0.84	0.75	1.17	1.01
1–4 family residential mortgages	0.77	0.74	0.65	0.66	0.73	0.72	1.11	0.88
Home equity loans	0.29	0.44	0.37	0.45	0.51	0.48	0.43	0.33
Multifamily residential mortgages	0.54	0.44	0.70	0.43	0.81	0.59	1.03	1.57
Commercial RE loans	1.01	0.89	0.78	0.71	1.06	0.88	1.36	1.05
Construction RE loans	0.98	0.69	0.85	0.62	0.92	0.66	1.15	1.07
Commercial and industrial loans*	2.60	2.85	1.48	1.63	0.84	0.85	0.82	0.96
Loans to individuals	0.79	0.75	0.77	0.88	1.52	1.61	1.48	1.68
Credit cards	1.65	1.56	2.06	2.38	2.02	2.19	1.91	2.00
Installment loans	0.72	0.71	0.48	0.54	0.71	0.64	1.23	1.47
All other loans and leases	na	na	na	na	0.50	0.42	0.27	0.48
Percent of loans charged-off, net								
Total loans and leases	0.19	0.18	0.33	0.37	1.46	1.25	0.56	0.68
Loans secured by real estate (RE)	0.01	0.03	0.03	0.02	0.04	0.07	0.06	0.08
1–4 family residential mortgages	0.02	0.02	0.03	0.04	0.05	0.12	0.08	0.09
Home equity loans	0.06	0.01	0.06	0.04	0.30	0.38	0.20	0.18
Multifamily residential mortgages	–0.10	–0.12	0.04	0.13	0.00	0.01	–0.04	–0.03
Commercial RE loans	0.01	0.08	0.03	0.01	–0.04	–0.07	–0.03	0.04
Construction RE loans	0.05	0.05	0.04	0.02	–0.01	0.00	0.00	0.04
Commercial and industrial loans*	0.29	0.41	0.22	0.42	0.05	0.21	0.26	0.48
Loans to individuals	0.87	0.65	1.62	1.71	4.06	3.63	2.61	2.77
Credit cards	3.35	2.88	5.83	6.48	5.79	5.20	4.47	4.67
Installment loans	0.60	0.53	0.65	0.58	1.15	0.88	1.43	1.49
All other loans and leases	na	na	na	na	0.27	0.15	0.16	0.27
Loans outstanding ($)								
Total loans and leases	$38,641	$35,259	$161,854	$155,096	$312,559	$287,095	$1,367,693	$1,539,349
Loans secured by real estate (RE)	21,657	19,920	97,430	93,186	124,450	122,371	500,014	521,438
1–4 family residential mortgages	10,830	9,614	46,879	43,283	60,729	61,010	256,045	254,715
Home equity loans	506	398	4,550	3,786	10,712	8,606	51,262	52,376
Multifamily residential mortgages	492	431	3,371	3,051	4,528	4,987	15,596	16,007
Commercial RE loans	6,016	5,704	31,842	31,725	36,853	35,016	119,129	129,706
Construction RE loans	1,479	1,462	7,168	7,490	9,788	11,193	31,025	39,155
Farmland loans	2,336	2,309	3,604	3,826	1,701	1,372	2,726	3,484
RE loans from foreign offices	0	0	16	25	139	187	24,230	25,996
Commercial and industrial loans	6,623	6,153	28,895	28,131	62,859	58,391	429,630	509,107
Loans to individuals	5,923	5,045	26,257	24,329	106,247	88,580	220,182	246,891
Credit cards	443	237	4,741	4,548	65,823	55,100	83,274	97,551
Installment loans	5,480	4,808	21,516	19,781	40,424	33,480	136,908	149,340
All other loans and leases	4,597	4,265	9,654	9,785	19,181	17,864	219,284	263,266
Less: Unearned income	158	123	382	335	178	111	1,416	1,353

* Includes "All other loans" for institutions $1 billion in asset size.

Key indicators, FDIC-insured national banks by region
First quarter 1999
(Dollar figures in millions)

	Northeast	Southeast	Central	Midwest	Southwest	West	All institutions
Number of institutions reporting	269	320	504	483	607	249	2,432
Total employees (FTEs)	263,152	248,617	161,575	75,020	72,736	141,817	962,917
Selected income data ($)							
Net income	$2,996	$2,479	$1,713	$992	$510	$1,845	$10,535
Net interest income	8,024	6,894	4,367	2,486	1,906	4,988	28,665
Provision for loan losses	1,700	616	505	387	182	690	4,080
Noninterest income	8,504	4,603	3,086	1,857	756	3,743	22,550
Noninterest expense	10,072	7,308	4,452	2,445	1,763	5,126	31,166
Net operating income	3,000	2,379	1,668	977	486	1,805	10,315
Cash dividends declared	1,519	1,198	807	768	323	565	5,180
Net charge-offs to loan and lease reserve	1,524	643	425	379	149	570	3,691
Selected condition data ($)							
Total assets	849,003	823,289	506,668	242,445	205,556	514,384	3,141,344
Total loans and leases	537,034	514,507	339,775	165,903	115,295	344,285	2,016,799
Reserve for losses	11,736	7,573	5,222	2,984	1,606	8,146	37,266
Securities	133,279	162,226	86,604	40,041	55,404	49,860	527,414
Other real estate owned	597	481	197	84	134	331	1,824
Noncurrent loans and leases	7,502	4,457	2,869	1,384	1,258	2,774	20,244
Total deposits	563,116	511,351	329,846	163,320	164,699	369,027	2,101,359
Domestic deposits	337,995	480,200	300,581	157,111	162,218	308,961	1,747,066
Equity capital	72,356	76,469	42,932	20,326	17,721	48,927	278,731
Off-balance-sheet derivatives	4,112,655	3,055,104	1,529,743	44,440	33,853	1,945,023	10,720,818
Performance ratios (annualized %)							
Return on equity	16.84	12.98	16.09	19.63	11.52	15.27	15.25
Return on assets	1.41	1.20	1.33	1.62	0.99	1.42	1.33
Net interest income to assets	3.79	3.32	3.40	4.07	3.70	3.83	3.63
Loss provision to assets	0.80	0.30	0.39	0.63	0.35	0.53	0.52
Net operating income to assets	1.42	1.15	1.30	1.60	0.94	1.39	1.30
Noninterest income to assets	4.01	2.22	2.40	3.04	1.47	2.87	2.85
Noninterest expense to assets	4.75	3.52	3.46	4.00	3.42	3.94	3.94
Loss provision to loans and leases	1.27	0.48	0.59	0.92	0.63	0.80	0.81
Net charge-offs to loans and leases	1.14	0.50	0.50	0.90	0.52	0.66	0.73
Loss provision to net charge-offs	111.57	95.71	118.63	102.24	122.64	120.96	110.56
Performance ratios (%)							
Percent of institutions unprofitable	2.23	12.50	3.37	3.11	6.92	9.24	5.88
Percent of institutions with earnings gains	63.20	56.25	56.15	48.86	47.12	57.43	53.37
Nonint. income to net operating revenue	51.45	40.04	41.41	42.76	28.40	42.87	44.03
Nonint. expense to net operating revenue	60.94	63.56	59.74	56.29	66.20	58.71	60.85
Condition ratios (%)							
Nonperforming assets to assets	0.97	0.60	0.61	0.61	0.68	0.61	0.71
Noncurrent loans to loans	1.40	0.87	0.84	0.83	1.09	0.81	1.00
Loss reserve to noncurrent loans	156.44	169.89	182.01	215.57	127.68	293.67	184.09
Loss reserve to loans	2.19	1.47	1.54	1.80	1.39	2.37	1.85
Equity capital to assets	8.52	9.29	8.47	8.38	8.62	9.51	8.87
Leverage ratio	7.52	7.48	7.45	7.70	7.64	7.56	7.52
Risk-based capital ratio	12.50	11.46	11.76	12.28	13.15	12.02	12.04
Net loans and leases to assets	61.87	61.57	66.03	67.20	55.31	65.35	63.02
Securities to assets	15.70	19.70	17.09	16.52	26.95	9.69	16.79
Appreciation in securities (% of par)	0.18	-0.14	0.46	0.62	0.24	0.22	0.17
Residential mortgage assets to assets	15.63	26.97	20.47	20.38	23.02	14.59	20.06
Total deposits to assets	66.33	62.11	65.10	67.36	80.12	71.74	66.89
Core deposits to assets	33.94	51.81	52.23	59.02	69.16	54.16	49.13
Volatile liabilities to assets	44.61	30.62	29.04	23.32	18.95	26.75	32.18

Loan performance, FDIC-insured national banks by region
Fourth quarter 1999
(Dollar figures in millions)

	Northeast	Southeast	Central	Midwest	Southwest	West	All institutions
Percent of loans past due 30–89 days							
Total loans and leases	1.23	1.02	1.38	1.49	1.46	0.95	1.19
Loans secured by real estate (RE)	1.26	0.92	1.39	1.28	1.47	1.10	1.17
1–4 family residential mortgages	1.46	0.76	1.40	1.37	1.52	1.44	1.20
Home equity loans	0.93	0.34	0.98	0.71	0.65	0.95	0.75
Multifamily residential mortgages	0.44	4.88	1.11	1.13	1.32	0.45	1.83
Commercial RE loans	0.76	0.87	1.27	0.97	1.30	0.83	0.98
Construction RE loans	0.84	1.41	2.49	1.69	1.93	1.24	1.63
Commercial and industrial loans*	0.64	0.68	1.11	1.36	1.55	0.76	0.85
Loans to individuals	2.58	2.60	2.12	2.18	1.49	1.72	2.28
Credit cards	2.57	2.16	2.26	2.35	0.95	1.92	2.35
Installment loans	2.60	2.74	2.08	1.99	1.51	1.52	2.22
All other loans and leases	0.34	0.44	1.00	1.12	1.05	0.44	0.57
Percent of loans noncurrent							
Total loans and leases	1.40	0.87	0.84	0.83	1.09	0.81	1.00
Loans secured by real estate (RE)	1.41	0.84	0.82	0.64	1.09	0.70	0.93
1–4 family residential mortgages	1.07	0.72	0.87	0.61	0.90	0.76	0.83
Home equity loans	0.53	0.25	0.40	0.28	0.29	0.35	0.36
Multifamily residential mortgages	1.07	2.57	0.72	0.34	0.61	0.60	1.21
Commercial RE loans	1.37	0.98	0.91	0.53	1.35	0.67	0.96
Construction RE loans	0.96	0.99	0.75	0.91	0.93	1.00	0.92
Commercial and industrial loans*	1.13	0.85	0.99	0.92	1.47	0.88	1.00
Loans to individuals	2.42	1.27	0.91	1.14	0.42	1.60	1.59
Credit cards	2.14	1.41	1.89	1.57	0.61	2.85	2.08
Installment loans	2.91	1.22	0.66	0.64	0.42	0.29	1.23
All other loans and leases	0.38	0.58	0.52	0.70	1.28	0.30	0.47
Percent of loans charged-off, net							
Total loans and leases	1.14	0.50	0.50	0.90	0.52	0.66	0.73
Loans secured by real estate (RE)	0.10	0.09	0.06	0.07	0.10	0.01	0.07
1–4 family residential mortgages	0.10	0.07	0.08	0.11	0.11	0.08	0.08
Home equity loans	0.32	0.22	0.19	0.19	0.63	0.06	0.20
Multifamily residential mortgages	–0.04	0.04	0.00	0.05	–0.04	–0.06	–0.01
Commercial RE loans	–0.09	0.10	0.01	0.00	0.13	–0.08	0.02
Construction RE loans	–0.07	0.12	–0.01	0.04	–0.01	–0.04	0.03
Commercial and industrial loans*	0.46	0.54	0.31	0.17	0.50	0.51	0.45
Loans to individuals	3.91	2.01	1.99	3.22	1.18	2.97	2.89
Credit cards	4.92	4.69	5.54	5.03	2.42	4.76	4.91
Installment loans	2.07	1.02	1.10	1.05	1.13	1.01	1.29
All other loans and leases	0.03	0.28	0.36	0.68	0.95	0.19	0.26
Loans outstanding ($)							
Total loans and leases	$537,034	$514,507	$339,775	$165,903	$115,295	$344,285	$2,016,799
Loans secured by real estate (RE)	153,876	235,241	138,763	66,005	47,326	115,703	756,914
1–4 family residential mortgages	79,409	125,467	61,966	34,169	20,074	47,538	368,623
Home equity loans	11,413	20,072	15,149	3,628	877	14,027	65,167
Multifamily residential mortgages	5,200	6,312	4,926	1,992	1,360	4,685	24,476
Commercial RE loans	29,294	61,494	42,205	17,180	17,209	34,770	202,151
Construction RE loans	5,244	19,470	11,985	6,049	6,231	10,321	59,300
Farmland loans	454	2,219	2,516	2,988	1,575	1,238	10,990
RE loans from foreign offices	22,862	207	16	0	0	3,124	26,208
Commercial and industrial loans	171,697	152,547	97,817	41,346	33,989	104,385	601,782
Loans to individuals	126,575	67,704	56,744	39,103	22,974	51,744	364,844
Credit cards	80,135	17,281	11,649	20,885	865	26,622	157,436
Installment loans	46,441	50,422	45,095	18,219	22,110	25,122	207,408
All other loans and leases	85,967	59,283	46,592	19,473	11,202	72,662	295,180
Less: Unearned income	1,082	268	141	25	197	209	1,922

*Includes “All other loans” for institutions under $1 billion in asset size.

Key indicators, FDIC-insured commercial banks
Annual 1995–1998, year-to-date through March 31, 1999, first quarter 1998, and first quarter 1999
(Dollar figures in millions)

	1995	1996	1997	1998	Preliminary 1999YTD	1998Q1	Preliminary 1999Q1
Number of institutions reporting	9,940	9,527	9,142	8,774	8,721	9,023	8,721
Total employees (FTEs)	1,484,421	1,489,186	1,538,408	1,627,047	1,619,398	1,557,251	1,619,398
Selected income data ($)							
Net income	$48,745	$52,351	$59,160	$61,820	$17,973	$15,918	$17,973
Net interest income	154,210	162,754	174,507	182,760	47,388	44,315	47,388
Provision for loan losses	12,603	16,285	19,850	22,189	5,414	4,833	5,414
Noninterest income	82,426	93,569	104,498	123,702	34,722	29,061	34,722
Noninterest expense	149,729	160,698	169,984	194,120	49,633	45,716	49,633
Net operating income	48,396	51,510	57,932	59,266	17,623	14,862	17,623
Cash dividends declared	31,053	38,791	42,541	41,102	9,095	10,828	9,095
Net charge-offs to loan and lease reserve	12,202	15,500	18,316	20,708	5,005	4,664	5,005
Selected condition data ($)							
Total assets	4,312,676	4,578,314	5,014,950	5,441,101	5,409,723	5,109,096	5,409,723
Total loans and leases	2,602,963	2,811,279	2,970,767	3,238,411	3,250,948	3,023,468	3,250,948
Reserve for losses	52,838	53,458	54,684	57,246	57,858	55,200	57,858
Securities	810,872	800,648	871,868	979,704	995,427	905,405	995,427
Other real estate owned	6,063	4,780	3,795	3,149	3,136	3,734	3,136
Noncurrent loans and leases	30,351	29,130	28,542	31,248	32,226	29,505	32,226
Total deposits	3,027,574	3,197,136	3,421,726	3,681,472	3,637,185	3,467,394	3,637,185
Domestic deposits	2,573,480	2,723,556	2,895,532	3,109,438	3,062,459	2,938,821	3,062,459
Equity capital	349,571	375,270	417,777	462,172	469,592	429,788	469,592
Off-balance-sheet derivatives	16,860,614	20,035,444	25,063,799	32,999,486	32,662,264	26,049,239	32,662,264
Performance ratios (annualized %)							
Return on equity	14.66	14.45	14.69	13.94	15.41	15.02	15.41
Return on assets	1.17	1.19	1.23	1.19	1.32	1.26	1.32
Net interest income to assets	3.71	3.70	3.64	3.51	3.49	3.50	3.49
Loss provision to assets	0.30	0.37	0.41	0.43	0.40	0.38	0.40
Net operating income to assets	1.16	1.17	1.21	1.14	1.30	1.17	1.30
Noninterest income to assets	1.98	2.13	2.18	2.37	2.55	2.30	2.55
Noninterest expense to assets	3.60	3.65	3.54	3.73	3.65	3.61	3.65
Loss provision to loans and leases	0.51	0.61	0.69	0.72	0.67	0.64	0.67
Net charge-offs to loans and leases	0.49	0.58	0.64	0.67	0.62	0.62	0.62
Loss provision to net charge-offs	103.28	105.07	108.37	104.84	108.20	103.26	108.20
Performance ratios (%)							
Percent of institutions unprofitable	3.55	4.27	4.85	6.01	6.00	4.56	6.00
Percent of institutions with earnings gains	67.53	70.77	68.39	61.50	52.83	62.96	52.46
Nonint. income to net operating revenue	34.83	36.50	37.45	40.36	42.29	39.61	42.29
Nonint. expense to net operating revenue	63.27	62.69	60.92	63.34	60.45	62.30	60.45
Condition ratios (%)							
Nonperforming assets to assets	0.85	0.75	0.66	0.65	0.67	0.67	0.67
Noncurrent loans to loans	1.17	1.04	0.96	0.96	0.99	0.98	0.99
Loss reserve to noncurrent loans	174.09	183.51	191.59	183.20	179.54	187.09	179.54
Loss reserve to loans	2.03	1.90	1.84	1.77	1.78	1.83	1.78
Equity capital to assets	8.11	8.20	8.33	8.49	8.68	8.41	8.68
Leverage ratio	7.61	7.64	7.56	7.54	7.68	7.56	7.68
Risk-based capital ratio	12.68	12.54	12.25	12.23	12.42	12.38	12.42
Net loans and leases to assets	59.13	60.24	58.15	58.47	59.02	58.10	59.02
Securities to assets	18.80	17.49	17.39	18.01	18.40	17.72	18.40
Appreciation in securities (% of par)	1.01	0.51	1.10	1.07	0.39	1.06	0.39
Residential mortgage assets to assets	20.31	19.79	20.03	20.93	20.50	20.40	20.50
Total deposits to assets	70.20	69.83	68.23	67.66	67.23	67.87	67.23
Core deposits to assets	53.47	52.45	50.06	49.40	48.80	49.60	48.80
Volatile liabilities to assets	29.68	30.71	31.92	31.68	32.35	32.23	32.35

Loan performance, FDIC-insured commercial banks
Annual 1995–1998, year-to-date through March 31, 1999, first quarter 1998, and first quarter 1999

(Dollar figures in millions)

	1995	1996	1997	1998	Preliminary 1999YTD	1998Q1	Preliminary 1999Q1
Percent of loans past due 30–89 days							
Total loans and leases	1.29	1.37	1.31	1.26	1.20	1.29	1.20
Loans secured by real estate (RE)	1.38	1.41	1.33	1.26	1.15	1.28	1.15
1–4 family residential mortgages	1.53	1.57	1.59	1.44	1.23	1.41	1.23
Home equity loans	1.09	1.06	0.96	0.98	0.79	0.88	0.79
Multifamily residential mortgages	0.99	1.19	1.11	0.87	1.36	0.91	1.36
Commercial RE loans	1.21	1.24	0.97	0.99	0.96	1.09	0.96
Construction RE loans	1.41	1.58	1.42	1.50	1.44	1.53	1.44
Commercial and industrial loans*	0.86	0.95	0.83	0.88	0.95	0.93	0.95
Loans to individuals	2.21	2.50	2.50	2.43	2.22	2.27	2.22
Credit cards	2.40	2.76	2.73	2.58	2.41	2.58	2.41
Installment loans	2.08	2.31	2.33	2.33	2.10	2.08	2.10
All other loans and leases	0.37	0.37	0.51	0.51	0.59	0.65	0.59
Percent of loans noncurrent							
Total loans and leases	1.17	1.04	0.96	0.96	0.99	0.98	0.99
Loans secured by real estate (RE)	1.39	1.20	1.01	0.91	0.88	1.00	0.88
1–4 family residential mortgages	0.88	0.99	0.94	0.88	0.81	0.90	0.81
Home equity loans	0.52	0.48	0.44	0.42	0.39	0.45	0.39
Multifamily residential mortgages	1.99	1.35	0.95	0.84	0.93	0.90	0.93
Commercial RE loans	2.02	1.61	1.21	0.95	0.92	1.18	0.92
Construction RE loans	2.75	1.38	0.97	0.81	0.89	1.06	0.89
Commercial and industrial loans*	1.19	0.98	0.86	0.99	1.10	0.97	1.10
Loans to individuals	1.22	1.36	1.47	1.52	1.51	1.44	1.51
Credit cards	1.58	1.91	2.18	2.22	2.21	2.18	2.21
Installment loans	0.97	0.97	0.98	1.06	1.08	0.97	1.08
All other loans and leases	0.30	0.22	0.25	0.34	0.45	0.26	0.45
Percent of loans charged-off, net							
Total loans and leases	0.49	0.58	0.64	0.67	0.62	0.62	0.62
Loans secured by real estate (RE)	0.18	0.10	0.06	0.05	0.05	0.04	0.05
1–4 family residential mortgages	0.11	0.08	0.08	0.07	0.07	0.06	0.07
Home equity loans	0.20	0.20	0.16	0.14	0.16	0.17	0.16
Multifamily residential mortgages	0.32	0.15	0.04	0.05	–0.01	–0.02	–0.01
Commercial RE loans	0.32	0.09	0.01	0.00	–0.00	–0.00	0.00
Construction RE loans	0.22	0.19	–0.02	0.01	0.03	0.01	0.03
Commercial and industrial loans*	0.25	0.26	0.28	0.42	0.44	0.29	0.44
Loans to individuals	1.73	2.28	2.70	2.69	2.54	2.70	2.54
Credit cards	3.40	4.35	5.11	5.19	4.94	5.15	4.94
Installment loans	0.66	0.89	1.04	1.04	1.02	1.06	1.02
All other loans and leases	–0.07	0.25	0.32	1.55	0.25	0.23	0.25
Loans outstanding ($)							
Total loans and leases	$2,602,963	$2,811,279	$2,970,767	$3,238,411	$3,250,948	$3,023,468	$3,250,948
Loans secured by real estate (RE)	1,080,116	1,139,018	1,244,986	1,345,502	1,346,292	1,273,776	1,346,292
1–4 family residential mortgages	546,808	570,122	620,599	668,659	653,102	640,105	653,102
Home equity loans	79,182	85,300	98,163	96,646	95,589	96,807	95,589
Multifamily residential mortgages	35,788	38,162	41,231	42,727	45,434	42,121	45,434
Commercial RE loans	298,533	315,989	341,522	371,021	380,499	347,472	380,499
Construction RE loans	68,696	76,399	88,242	106,719	111,906	90,812	111,906
Farmland loans	23,907	24,964	27,072	29,095	29,573	27,556	29,573
RE loans from foreign offices	27,202	28,083	28,157	30,635	30,188	28,904	30,188
Commercial and industrial loans	661,417	709,600	794,999	898,723	921,734	819,121	921,734
Loans to individuals	535,348	562,291	561,351	570,959	548,536	542,136	548,536
Credit cards	216,016	231,664	231,118	228,834	207,891	211,775	207,891
Installment loans	319,332	330,626	330,233	342,125	340,645	330,361	340,645
All other loans and leases	331,934	405,678	373,901	427,260	438,048	392,763	438,048
Less: Unearned income	5,853	5,308	4,469	4,032	3,663	4,328	3,663

*Includes "All other loans" for institutions under $1 billion in asset size.

Key indicators, FDIC-insured commercial banks by asset size
First quarter 1998 and first quarter 1999

(Dollar figures in millions)

	Less than $100M 1998Q1	Less than $100M 1999Q1	$100M to $1B 1998Q1	$100M to $1B 1999Q1	$1B to $10B 1998Q1	$1B to $10B 1999Q1	Greater than $10B 1998Q1	Greater than $10B 1999Q1
Number of institutions reporting	5,742	5,375	2,918	2,956	298	317	65	73
Total employees (FTEs)	124,952	115,741	311,207	300,930	294,010	292,594	827,082	910,133
Selected income data ($)								
Net income	$780	$687	$2,464	$2,356	$3,854	$3,920	$8,820	$11,010
Net interest income	2,750	2,479	7,538	7,429	9,328	9,348	24,698	28,132
Provision for loan losses	135	122	466	547	1,501	1,379	2,731	3,366
Noninterest income	833	833	2,877	2,850	5,792	7,460	19,560	23,580
Noninterest expense	2,372	2,265	6,365	6,357	8,568	9,360	28,411	31,650
Net operating income	771	684	2,429	2,330	3,256	3,874	8,406	10,736
Cash dividends declared	531	443	1,232	1,304	1,887	2,084	7,179	5,264
Net charge-offs to loan and lease reserve	65	62	313	381	1,534	1,203	2,753	3,358
Selected condition data ($)								
Total assets	263,838	250,491	728,952	727,138	899,726	901,225	3,216,580	3,530,870
Total loans and leases	154,173	144,503	443,244	445,706	589,210	580,482	1,836,842	2,080,256
Reserve for losses	2,287	2,132	6,675	6,760	12,624	11,955	33,615	37,011
Securities	71,197	69,090	190,945	197,286	186,397	198,320	456,865	530,730
Other real estate owned	338	277	834	756	601	493	1,961	1,609
Noncurrent loans and leases	1,639	1,596	3,991	3,893	6,228	5,730	17,647	21,006
Total deposits	226,719	214,205	603,285	598,155	618,763	618,999	2,018,628	2,205,827
Domestic deposits	226,681	214,169	601,003	596,069	600,823	604,095	1,510,314	1,648,127
Equity capital	28,715	27,713	70,066	69,795	86,198	88,218	244,809	283,865
Off-balance-sheet derivatives	769	248	9,906	8,956	125,699	111,703	26,590,375	33,077,511
Performance ratios (annualized %)								
Return on equity	10.92	9.94	14.25	13.60	18.30	17.78	14.59	15.64
Return on assets	1.19	1.10	1.37	1.30	1.72	1.71	1.11	1.24
Net interest income to assets	4.21	3.97	4.18	4.10	4.16	4.08	3.10	3.17
Loss provision to assets	0.21	0.20	0.26	0.30	0.67	0.60	0.34	0.38
Net operating income to assets	1.18	1.10	1.35	1.29	1.45	1.69	1.06	1.21
Noninterest income to assets	1.27	1.34	1.60	1.57	2.59	3.26	2.46	2.66
Noninterest expense to assets	3.63	3.63	3.53	3.51	3.82	4.09	3.57	3.57
Loss provision to loans and leases	0.35	0.34	0.42	0.50	1.02	0.94	0.60	0.65
Net charge-offs to loans and leases	0.17	0.17	0.28	0.35	1.04	0.82	0.61	0.65
Loss provision to net charge-offs	208.38	195.83	148.98	143.48	97.67	114.66	98.73	100.25
Performance ratios (%)								
Percent of institutions unprofitable	6.37	8.80	1.37	1.45	1.34	1.89	1.54	1.37
Percent of institutions with earnings gains	58.06	46.14	71.32	61.87	73.15	67.19	73.85	72.60
Nonint. income to net operating revenue	23.24	25.16	27.62	27.73	38.31	44.38	44.19	45.60
Nonint. expense to net operating revenue	66.21	68.40	61.11	61.85	56.67	55.69	64.19	61.20
Condition ratios (%)								
Nonperforming assets to assets	0.75	0.75	0.66	0.64	0.76	0.69	0.65	0.67
Noncurrent loans to loans	1.06	1.10	0.90	0.87	1.06	0.99	0.96	1.01
Loss reserve to noncurrent loans	139.55	133.53	167.25	173.66	202.71	208.64	190.48	176.19
Loss reserve to loans	1.48	1.48	1.51	1.52	2.14	2.06	1.83	1.78
Equity capital to assets	10.88	11.06	9.61	9.60	9.58	9.79	7.61	8.04
Leverage ratio	10.72	10.85	9.23	9.22	8.60	8.61	6.63	6.91
Risk-based capital ratio	18.07	18.24	15.00	14.87	13.34	13.44	11.30	11.47
Net loans and leases to assets	57.57	56.84	59.89	60.37	64.08	63.08	56.06	57.87
Securities to assets	26.99	27.58	26.19	27.13	20.72	22.01	14.20	15.03
Appreciation in securities (% of par)	0.74	0.42	0.98	0.60	0.85	0.34	1.24	0.33
Residential mortgage assets to assets	21.56	21.05	24.46	24.49	24.31	26.14	18.30	18.19
Total deposits to assets	85.93	85.51	82.76	82.26	68.77	68.68	62.76	62.47
Core deposits to assets	74.92	74.10	71.44	70.52	57.26	57.38	40.43	40.35
Volatile liabilities to assets	12.32	12.64	15.87	16.17	26.01	25.07	39.31	38.94

Loan performance, FDIC-insured commercial banks by asset size
First quarter 1998 and first quarter 1999

(Dollar figures in millions)

	Less than $100M		$100M to $1B		$1B to $10B		Greater than $10B	
	1998Q1	1999Q1	1998Q1	1999Q1	1998Q1	1999Q1	1998Q1	1999Q1
Percent of loans past due 30–89 days								
Total loans and leases	1.92	1.85	1.44	1.37	1.54	1.39	1.11	1.07
Loans secured by real estate (RE)	1.63	1.54	1.23	1.11	1.20	1.12	1.29	1.14
1–4 family residential mortgages	1.92	1.78	1.47	1.37	1.23	1.14	1.39	1.16
Home equity loans	1.06	0.93	0.87	0.81	0.93	0.85	0.86	0.76
Multifamily residential mortgages	0.97	0.88	0.85	0.78	0.83	0.70	0.97	1.97
Commercial RE loans	1.22	1.17	0.97	0.85	1.09	1.00	1.15	0.96
Construction RE loans	1.28	1.20	1.28	1.05	1.84	1.70	1.56	1.52
Commercial and industrial loans*	2.20	2.21	1.66	1.64	1.21	1.27	0.61	0.68
Loans to individuals	2.42	2.28	1.93	2.02	2.41	2.11	2.27	2.29
Credit cards	2.90	2.38	2.42	3.56	2.62	2.34	2.57	2.35
Installment loans	2.39	2.27	1.83	1.73	2.18	1.86	2.07	2.25
All other loans and leases	na	na	na	na	1.23	1.17	0.62	0.55
Percent of loans noncurrent								
Total loans and leases	1.06	1.10	0.90	0.87	1.06	0.99	0.96	1.01
Loans secured by real estate (RE)	0.89	0.87	0.79	0.71	0.90	0.83	1.14	0.96
1–4 family residential mortgages	0.79	0.77	0.69	0.67	0.81	0.82	1.03	0.85
Home equity loans	0.52	0.46	0.43	0.44	0.50	0.50	0.44	0.36
Multifamily residential mortgages	0.75	0.61	0.80	0.65	0.91	0.58	0.94	1.24
Commercial RE loans	0.94	0.87	0.89	0.73	1.12	0.93	1.42	1.03
Construction RE loans	0.80	0.71	0.96	0.71	0.94	0.83	1.24	1.04
Commercial and industrial loans*	1.47	1.65	1.26	1.32	0.90	1.01	0.84	1.00
Loans to individuals	0.88	0.88	0.78	0.82	1.55	1.42	1.58	1.72
Credit cards	1.64	1.91	1.74	1.99	2.10	2.14	2.29	2.27
Installment loans	0.84	0.83	0.59	0.60	0.95	0.63	1.12	1.37
All other loans and leases	na	na	na	na	0.49	0.48	0.24	0.47
Percent of loans charged-off, net								
Total loans and leases	0.17	0.17	0.28	0.35	1.04	0.82	0.61	0.65
Loans secured by real estate (RE)	0.02	0.03	0.03	0.03	0.06	0.05	0.05	0.06
1–4 family residential mortgages	0.03	0.03	0.02	0.05	0.07	0.09	0.07	0.07
Home equity loans	0.10	0.01	0.06	0.03	0.20	0.25	0.18	0.16
Multifamily residential mortgages	0.03	–0.02	–0.02	0.04	0.00	–0.03	–0.02	–0.02
Commercial RE loans	0.03	0.04	0.04	0.01	0.03	–0.03	–0.05	0.01
Construction RE loans	0.06	0.04	0.02	0.02	0.04	0.01	–0.02	0.03
Commercial and industrial loans*	0.21	0.24	0.22	0.39	0.13	0.30	0.32	0.47
Loans to individuals	0.63	0.60	1.42	1.66	3.42	2.98	2.75	2.63
Credit cards	3.01	2.32	5.14	7.18	5.53	4.88	4.90	4.81
Installment loans	0.48	0.52	0.66	0.60	1.01	0.83	1.27	1.23
All other loans and leases	na	na	na	na	0.26	0.21	0.25	0.28
Loans outstanding ($)								
Total loans and leases	$154,173	$144,503	$443,244	$445,706	$589,210	$580,482	$1,836,842	$2,080,256
Loans secured by real estate (RE)	86,767	81,650	274,506	277,489	263,198	282,269	649,306	704,883
1–4 family residential mortgages	42,869	38,745	123,390	120,102	127,691	133,895	346,155	360,361
Home equity loans	2,011	1,751	13,005	11,567	19,694	18,000	62,096	64,271
Multifamily residential mortgages	1,879	1,709	9,081	9,137	11,252	11,607	19,908	22,981
Commercial RE loans	23,296	22,700	94,445	98,916	79,195	87,936	150,537	170,947
Construction RE loans	6,082	6,133	24,146	26,296	21,794	27,301	38,789	52,176
Farmland loans	10,622	10,606	10,361	11,420	3,309	3,166	3,265	4,381
RE loans from foreign offices	8	7	77	51	263	364	28,555	29,765
Commercial and industrial loans	25,710	24,770	79,424	81,626	125,300	126,723	588,687	688,615
Loans to individuals	22,874	20,640	66,914	63,081	163,099	134,821	289,249	329,995
Credit cards	1,293	867	11,043	10,050	85,432	70,207	114,008	126,767
Installment loans	21,582	19,773	55,871	53,031	77,667	64,613	175,241	203,228
All other loans and leases	19,402	17,885	23,564	24,483	38,414	37,203	311,383	358,477
Less: Unearned income	580	441	1,164	973	801	534	1,782	1,714

* Includes "All other loans" for institutions under $1 billion in asset size.

Key indicators, FDIC-insured commercial banks by region
First quarter 1999
(Dollar figures in millions)

	Northeast	Southeast	Central	Midwest	Southwest	West	All Institutions
Number of institutions reporting	684	1,440	1,897	2,252	1,502	946	8,721
Total employees (FTEs)	477,983	398,370	284,546	126,430	116,526	215,543	1,619,398
Selected income data ($)							
Net income	$6,357	$3,801	$2,986	$1,423	$805	$2,603	$17,973
Net interest income	14,832	10,673	7,596	3,782	2,886	7,619	47,388
Provision for loan losses	2,105	877	690	469	239	1,034	5,414
Noninterest income	15,824	6,461	4,623	2,180	1,004	4,631	34,722
Noninterest expense	18,694	10,714	7,195	3,384	2,531	7,115	49,633
Net operating income	6,270	3,688	2,927	1,404	780	2,555	17,623
Cash dividends declared	3,346	1,934	1,421	1,041	493	859	9,095
Net charge-offs to loan and lease reserve	2,122	832	574	440	181	856	5,005
Selected condition data ($)							
Total assets	1,922,368	1,206,559	873,605	371,683	302,829	732,680	5,409,723
Total loans and leases	1,003,176	765,755	579,793	247,591	167,569	487,063	3,250,948
Reserve for losses	20,416	11,173	8,653	4,298	2,338	10,981	57,858
Securities	316,268	250,598	171,142	74,288	87,065	96,065	995,427
Other real estate owned	929	799	378	200	256	573	3,136
Noncurrent loans and leases	12,757	6,310	4,720	2,125	1,798	4,515	32,226
Total deposits	1,182,635	796,875	600,590	271,969	246,893	538,223	3,637,185
Domestic deposits	758,907	759,770	561,795	265,760	244,411	471,816	3,062,459
Equity capital	152,730	111,061	74,834	33,138	27,052	70,777	469,592
Off-balance-sheet derivatives	25,914,402	3,119,127	1,585,997	45,347	34,472	1,962,920	32,662,264
Performance ratios (annualized %)							
Return on equity	16.75	13.71	16.10	17.26	11.95	14.89	15.41
Return on assets	1.32	1.26	1.36	1.52	1.06	1.41	1.32
Net interest income to assets	3.07	3.53	3.45	4.05	3.81	4.13	3.49
Loss provision to assets	0.44	0.29	0.31	0.50	0.32	0.56	0.40
Net operating income to assets	1.30	1.22	1.33	1.50	1.03	1.38	1.30
Noninterest income to assets	3.28	2.13	2.10	2.33	1.32	2.51	2.55
Noninterest expense to assets	3.88	3.54	3.27	3.62	3.34	3.86	3.65
Loss provision to loans and leases	0.84	0.46	0.48	0.75	0.57	0.85	0.67
Net charge-offs to loans and leases	0.84	0.44	0.40	0.71	0.43	0.70	0.62
Loss provision to net charge-offs	99.21	105.40	120.24	106.65	132.24	120.83	108.20
Performance ratios (%)							
Percent of institutions unprofitable	6.29	8.26	4.06	3.77	6.19	11.21	6.00
Percent of institutions with earnings gains	63.30	56.11	54.67	47.25	47.07	55.60	52.46
Nonint. income to net operating revenue	51.62	37.71	37.84	36.56	25.80	37.80	42.29
Nonint. expense to net operating revenue	60.98	62.53	58.88	56.77	65.06	58.08	60.45
Condition ratios (%)							
Nonperforming assets to assets	0.76	0.59	0.58	0.63	0.68	0.70	0.67
Noncurrent loans to loans	1.27	0.82	0.81	0.86	1.07	0.93	0.99
Loss reserve to noncurrent loans	160.03	177.06	183.32	202.25	130.03	243.19	179.54
Loss reserve to loans	2.04	1.46	1.49	1.74	1.40	2.25	1.78
Equity capital to assets	7.94	9.20	8.57	8.92	8.93	9.66	8.68
Leverage ratio	7.24	7.79	7.76	8.35	8.10	8.08	7.68
Risk-based capital ratio	12.53	11.97	12.08	13.18	13.97	12.43	12.42
Net loans and leases to assets	51.12	62.54	65.38	65.46	54.56	64.98	59.02
Securities to assets	16.45	20.77	19.59	19.99	28.75	13.11	18.40
Appreciation in securities (% of par)	0.09	0.66	0.52	0.60	0.31	0.38	0.39
Residential mortgage assets to assets	16.91	27.36	22.32	20.16	23.17	15.50	20.50
Total deposits to assets	61.52	66.05	68.75	73.17	81.53	73.46	67.23
Core deposits to assets	32.07	55.43	56.09	64.72	69.49	56.45	48.80
Volatile liabilities to assets	45.00	27.44	26.95	19.24	18.59	26.04	32.35

Loan performance, FDIC-insured commercial banks by region
First quarter 1999
(Dollar figures in millions)

	Northeast	Southeast	Central	Midwest	Southwest	West	All institutions
Percent of loans past due 30–89 days							
Total loans and leases	1.13	1.13	1.34	1.54	1.56	1.00	1.20
Loans secured by real estate (RE)	1.18	1.00	1.28	1.30	1.51	1.01	1.15
1–4 family residential mortgages	1.28	0.96	1.32	1.42	1.72	1.31	1.23
Home equity loans	0.87	0.55	0.94	0.74	0.83	0.89	0.79
Multifamily residential mortgages	0.66	3.37	1.13	0.90	1.12	0.54	1.36
Commercial RE loans	0.98	0.86	1.12	0.95	1.22	0.78	0.96
Construction RE loans	1.18	1.22	2.04	1.52	1.69	1.19	1.44
Commercial and industrial loans*	0.62	0.90	1.17	1.89	1.80	0.89	0.95
Loans to individuals	2.49	2.38	2.05	2.17	1.63	1.72	2.22
Credit cards	2.67	2.33	2.37	2.50	1.28	1.82	2.41
Installment loans	2.31	2.39	1.97	1.90	1.64	1.61	2.10
All other loans and leases	0.42	0.47	1.10	0.79	0.89	0.48	0.59
Percent of loans noncurrent							
Total loans and leases	1.27	0.82	0.81	0.86	1.07	0.93	0.99
Loans secured by real estate (RE)	1.18	0.77	0.74	0.67	1.00	0.84	0.88
1–4 family residential mortgages	0.96	0.71	0.75	0.62	0.90	0.87	0.81
Home equity loans	0.56	0.28	0.42	0.31	0.35	0.39	0.39
Multifamily residential mortgages	0.70	1.90	0.68	0.34	0.61	0.69	0.93
Commercial RE loans	1.30	0.85	0.80	0.57	1.11	0.84	0.92
Construction RE loans	1.24	0.78	0.75	0.87	0.87	1.10	0.89
Commercial and industrial loans*	1.21	0.86	1.02	1.23	1.60	1.09	1.10
Loans to individuals	2.24	1.14	0.92	1.09	0.52	1.48	1.51
Credit cards	2.47	1.48	2.20	1.66	0.82	2.43	2.21
Installment loans	2.01	1.03	0.62	0.62	0.51	0.38	1.08
All other loans and leases	0.43	0.53	0.46	0.47	1.01	0.31	0.45
Percent of loans charged-off, net							
Total loans and leases	0.84	0.44	0.40	0.71	0.43	0.70	0.62
Loans secured by real estate (RE)	0.04	0.07	0.05	0.05	0.08	0.03	0.05
1–4 family residential mortgages	0.06	0.06	0.07	0.08	0.10	0.10	0.07
Home equity loans	0.21	0.17	0.16	0.14	0.54	0.06	0.16
Multifamily residential mortgages	–0.05	0.02	0.01	0.03	–0.01	–0.05	–0.01
Commercial RE loans	–0.10	0.06	0.00	–0.00	0.09	–0.02	0.00
Construction RE loans	–0.03	0.08	0.00	0.05	0.00	–0.02	0.03
Commercial and industrial loans*	0.48	0.46	0.30	0.27	0.50	0.57	0.44
Loans to individuals	3.25	1.75	1.74	2.89	1.04	3.06	2.54
Credit cards	5.05	4.41	5.25	5.25	2.59	4.79	4.94
Installment loans	1.29	0.84	0.94	0.82	0.97	1.01	1.02
All other loans and leases	0.17	0.27	0.32	0.42	0.71	0.18	0.25
Loans outstanding ($)							
Total loans and leases	$1,003,176	$765,755	$579,793	$247,591	$167,569	$487,063	$3,250,948
Loans secured by real estate (RE)	323,290	385,963	261,452	109,697	75,557	190,332	1,346,292
1–4 family residential mortgages	180,222	197,153	121,873	52,563	31,821	69,470	653,102
Home equity loans	20,704	29,408	22,812	4,701	1,017	16,948	95,589
Multifamily residential mortgages	12,214	10,015	9,089	3,252	2,087	8,778	45,434
Commercial RE loans	70,631	104,807	78,784	29,540	27,814	68,922	380,499
Construction RE loans	12,268	38,908	21,554	9,959	9,639	19,577	111,906
Farmland loans	1,135	5,465	7,317	9,683	3,178	2,796	29,573
RE loans from foreign offices	26,116	207	23	0	0	3,841	30,188
Commercial and industrial loans	317,607	197,350	165,514	56,338	45,266	139,659	921,734
Loans to individuals	196,164	111,518	82,622	49,194	32,105	76,934	548,536
Credit cards	99,528	27,594	15,685	22,480	1,294	41,310	207,891
Installment loans	96,636	83,924	66,937	26,715	30,811	35,624	340,645
All other loans and leases	167,715	71,592	70,571	32,429	15,066	80,675	438,048
Less: Unearned income	1,600	667	366	67	425	537	3,663

*Includes “All other loans” for institutions under $1 billion in asset size.

Glossary

Data Sources

Data are from the Federal Financial Institutions Examination Council (FFIEC) Reports of Condition and Income (call reports) submitted by all FDIC-insured, national-chartered and state-chartered commercial banks and trust companies in the United States and its territories. Uninsured banks, savings banks, savings associations, and U.S. branches and agencies of foreign banks are excluded from these tables. All data are collected and presented based on the location of each reporting institution's main office. Reported data may include assets and liabilities located outside of the reporting institution's home state.

The data are stored on and retrieved from the OCC's Integrated Banking Information System (IBIS), which is obtained from the FDIC's Research Information System (RIS) database.

Computation Methodology

For performance ratios constructed by dividing an income statement (flow) item by a balance sheet (stock) item, the income item for the period was annualized (multiplied by the number of periods in a year) and divided by the average balance sheet item for the period (beginning-of-period amount plus end-of-period amount plus any interim periods, divided by the total number of periods). For "pooling-of-interest" mergers, prior period(s) balance sheet items of "acquired" institution(s) are included in balance sheet averages because the year-to-date income reported by the "acquirer" includes the year-to-date results of "acquired" institutions. No adjustments are made for "purchase accounting" mergers because the year-to-date income reported by the "acquirer" does not include the prior-to-merger results of "acquired" institutions.

Definitions

Commercial real estate loans—loans secured by nonfarm nonresidential properties.

Construction real estate loans—includes loans for all property types under construction, as well as loans for land acquisition and development.

Core deposits—the sum of transaction deposits plus savings deposits plus small time deposits (under $100,000).

IBIS—OCC's Integrated Banking Information System.

Leverage ratio—Tier 1 capital divided by adjusted tangible total assets.

Loans to individuals—includes outstanding credit card balances and other secured and unsecured installment loans.

Net charge-offs to loan and lease reserve—total loans and leases charged off (removed from balance sheet because of uncollectibility), less amounts recovered on loans and leases previously charged off.

Net loans and leases to assets—total loans and leases net of the reserve for losses.

Net operating income—income excluding discretionary transactions such as gains (or losses) on the sale of investment securities and extraordinary items. Income taxes subtracted from operating income have been adjusted to exclude the portion applicable to securities gains (or losses).

Net operating revenue—the sum of net interest income plus noninterest income.

Noncurrent loans and leases—the sum of loans and leases 90 days or more past due plus loans and leases in nonaccrual status.

Nonperforming assets—the sum of noncurrent loans and leases plus noncurrent debt securities and other assets plus other real estate owned.

Number of institutions reporting—the number of institutions that actually filed a financial report.

Off-balance-sheet derivatives—the notional value of futures and forwards, swaps, and options contracts; beginning March 31, 1995, new reporting detail permits the exclusion of spot foreign exchange contracts. For March 31, 1984 through December 31, 1985, only foreign exchange futures and forwards contracts were reported; beginning March 31, 1986, interest rate swaps contracts were reported; beginning March 31, 1990, banks began to report interest rate and other futures and forwards contracts, foreign exchange and other swaps contracts, and all types of option contracts.

Other real estate owned—primarily foreclosed property. Direct and indirect investments in real estate ventures are excluded. The amount is reflected net of valuation allowances.

Percent of institutions unprofitable—the percent of institutions with negative net income for the respective period.

Percent of institutions with earnings gains—the percent of institutions that increased their net income (or decreased their losses) compared to the same period a year earlier.

Reserve for losses—the sum of the allowance for loan and lease losses plus the allocated transfer risk reserve.

Residential mortgage assets—the sum of one- to four-family residential mortgages plus mortgage-backed securities.

Return on assets (ROA)—net income (including gains or losses on securities and extraordinary items) as a percentage of average total assets.

Return on equity (ROE)—net income (including gains or losses on securities and extraordinary items) as a percentage of average total equity capital.

Risk-based capital ratio—total capital divided by risk weighted assets.

Risk-weighted assets—assets adjusted for risk-based capital definitions which include on-balance-sheet as well as off-balance-sheet items multiplied by risk weights that range from zero to 100 percent.

Securities—excludes securities held in trading accounts. Effective March 31, 1994 with the full implementation of Financial Accounting Standard (FAS) 115, securities classified by banks as “held-to-maturity” are reported at their amortized cost, and securities classified a “available-for-sale” are reported at their current fair (market) values.

Securities gains (losses)—net pre-tax realized gains (losses) on held-to-maturity and available-for-sale securities.

Total capital—the sum of Tier 1 and Tier 2 capital. Tier 1 capital consists of common equity capital plus noncumulative perpetual preferred stock plus minority interest in consolidated subsidiaries less goodwill and other ineligible intangible assets. Tier 2 capital consists of subordinated debt plus intermediate-term preferred stock plus cumulative long-term preferred stock plus a portion of a bank’s allowance for loan and lease losses. The amount of eligible intangibles (including mortgage servicing rights) included in Tier 1 capital and the amount of the allowance included in Tier 2 capital are limited in accordance with supervisory capital regulations.

Volatile liabilities—the sum of large-denomination time deposits plus foreign-office deposits plus federal funds purchased plus securities sold under agreements to repurchase plus other borrowings. Beginning March 31, 1994, new reporting detail permits the exclusion of other borrowed money with original maturity of more than one year; previously, all other borrowed money was included. Also beginning March 31, 1994, the newly reported “trading liabilities less revaluation losses on assets held in trading accounts” is included.

Recent Corporate Decisions

The OCC publishes monthly, in its publication *Interpretations and Actions*, corporate decisions that represent a new or changed policy, or present issues of general interest to the public or the banking industry. In addition, summaries of selected corporate decisions appear in each issue of the *Quarterly Journal*. In the first quarter of 1999, the following corporate decisions were of particular importance because they were precedent setting or otherwise represented issues of importance. If the summary includes a decision or approval number, the OCC's decision documents may be found in *Interpretations and Actions*. For decisions that have not been published, the summary includes the application control number, which should be referenced in inquiries to the OCC regarding the decision.

Charter

On January 6, 1999, the OCC denied a charter proposal for Prosperity, South Carolina. The organizers failed to demonstrate that the proposed bank had a reasonable likelihood of success. In addition, the proposed executive officer and board of directors did not have the skills and experience that the OCC considers necessary to operate a national bank in a safe and sound manner. [Application Control No. 1998–SE–01–0020]

Insurance Subsidiaries

On December 21, 1998, the OCC granted approval for Old National Bank in Evansville, Indiana, to establish an operating subsidiary to provide insurance coverage on business risks of the parent bank and its bank affiliates, and to reinsure credit life, credit health and accident, and credit unemployment insurance. [Corporate Decision No. 99–03]

On December 28, 1998, the OCC granted approval for NationsBank, N.A., Charlotte, North Carolina, to establish an operating subsidiary to reinsure, under a quota share arrangement, a portion of the mortgage insurance on loans serviced, originated, or purchased by the bank or the bank's subsidiaries or depository institution affiliates. [Corporate Decision No. 99–05]

Operating Subsidiaries

On January 15, 1999, the OCC granted conditional approval to Bank of America, NT&SA, San Francisco, California, and Citibank, NA, New York, New York, to expand the activities of an existing operating subsidiary and thereby make minority, noncontrolling investments in a Delaware limited liability company (LLC). The initial activities of the LLC will be limited to research and development towards the eventual establishment of an identity verification service over open networks, including the Internet, based initially on digital signature technology. [Conditional Approval No. 301]

On January 29, 1999, the OCC granted approval for The Huntington National Bank, Columbus, Ohio, to expand the activities of an existing operating subsidiary. These activities include providing real estate closing and escrow services primarily to the bank and other lenders, and using its excess capacity to offer the services occasionally to customers when no loan or title policy is present. [Corporate Decision No. 99–06]

On March 5, 1999, the OCC granted conditional approval for Citibank, NA, New York, NY, to expand the activities of an existing operating subsidiary and thereby make a minority, non-controlling investment in the three Delaware limited liability companies (LLCs). The LLCs offer electronic bill payment and presentment services through the Internet. [Conditional Approval No. 304]

On March 19, 1999, the OCC granted conditional approval for Wells Fargo Bank, N.A., San Francisco, California, to expand the activities of an existing operating subsidiary to include holding a minority investment in a corporation that will sell and lease check cashing machines to third parties. [Conditional Approval No. 307]

On March 26, 1999, the OCC granted approval for National Bank of Commerce, Memphis, Tennessee, to establish an operating subsidiary to hold a leasehold interest in several historic structures and to receive rehabilitation tax credits under IRC 47. The tax credits, which could not be utilized by the bank's customer that is rehabilitating the historic structures, will be used to reduce the customer's borrowing costs on the rehabilitation financing provided by the bank. [Corporate Decision No. 99–07]

Community Reinvestment Act Decisions

On February 19, 1999, the OCC approved a series of transactions that resulted in the acquisition of Bank of America Texas, National Association, Dallas, Texas, and the New Mexico branches of Bank of America National Trust and

Savings Association, San Francisco, California, into NationsBank, National Association, Charlotte, North Carolina. While the OCC did not directly receive any comments on these transactions, the OCC investigated the concerns relating to the banks activities in Texas and New Mexico that were raised in letters and testimony received by the Federal Reserve Board in connection with the holding company merger application. The OCC's investigation and analysis of the issues raised indicated no basis for denying or conditionally approving the applications. However, BankAmerica Corporation (the parent holding company for NationsBank, National Association) represented to the OCC that it will provide public reports on its progress in meeting the goals of its publicly announced, 10-year, $350 billion community reinvestment and development commitment. BankAmerica Corporation will also provide the OCC with copies of every national, state, and local report produced during the life of the commitment. [CRA Decision No. 89]

On March 15, 1999, the OCC approved the merger of PNC National Bank (PNC), Wilmington, Delaware, a CEBA credit card bank, into MBNA America Bank, National Association (MBNA), Wilmington, Delaware. The OCC received a joint comment from two community organizations raising numerous concerns regarding MBNA's CRA performance. The community organization raised concerns with MBNA's defined CRA assessment area, the level of MBNA's community development loans, and the level of MBNA's support for housing and small business counseling. The OCC investigated those concerns and concluded that the bank's record of CRA performance was consistent with approval of this transaction. [CRA Decision No. 92]

Appeals Process

Appeal 1—Appeal of Composite CAMELS Rating of 3 and "Needs to Improve" CRA Rating

Background

A bank formally appealed the 3 management rating and the 3 composite rating assigned in its most recent report of examination (ROE). Senior management and the board believed the ratings were incorrect based on the following:

- Inappropriate characterization of matters requiring board attention (MRBA) as a repeat criticism; and
- Inappropriate criticism of the new product development process, when the bank had not yet incurred any exposure from these new products.

The bank also appealed the Community Reinvestment Act (CRA) rating of "Needs to Improve." The bank noted that rating was based on:

- A low percentage (22 percent) of the bank's lending in its assessment area, and
- A small percentage of the bank's lending to businesses of different sizes; 16 percent of the bank's commercial loans were to small businesses, and 27 percent of the loans were of a loan amount less than $100,000.

The bank concurred with the percentages arrived at, but disagreed with the individual component ratings assigned to "Lending in the Assessment Area" and "Lending to Borrowers of Different Incomes and to Businesses of Different Sizes." Senior management of the bank believed the statistics were reasonable when their business strategy was taken into account. The appeal also noted the bank's prior CRA rating was "outstanding."

Factual Errors

The appeal submission detailed what management believed were five factual errors in the ROE:

- The statement that the increase in nonaccrual loans was due to an OCC examination finding.
- The statement that qualitative factors are not used in the analysis of the allowance for loan and lease losses (ALLL), and that management does not review changes in the composition of classified assets in analyzing the ALLL.
- The statement in the ROE that financial statement spreads are incorrect, and that debt service coverage analysis has been frequently manipulated to show coverage in the best possible light.
- The matters requiring board attention (MRBA) reflected as repeat criticisms.
- The recommendation to formalize the new product process to include comprehensive and formalized risk analysis.

Increase in Nonaccrual Loans

In the appeal, bank management objected to the bank initiated increase in nonaccrual loans being reflected as OCC adjustments. Once an examination has commenced, it is OCC procedure to reflect all loan status changes in the examination conclusions. If the changes were a result of management action, it is appropriate to reflect that management initiated the changes, but this does not preclude the changes from being reflected as part of the examination conclusions.

Analysis of the Allowance for Loan and Lease Loss

Comments in the ROE indicated management had not been using qualitative factors to estimate inherent loss in the Pass portion of the loan portfolio, such as changes in the volume and severity of past due and classified loans. The appeal stated the bank has been using a dual methodology for reviewing the adequacy of the allowance for loan and lease losses (ALLL). The bank's methodology included a comparison to an independent benchmark and using the format outlined in Banking Circular 201 (including consideration of qualitative factors); and have used this methodology for several years. The appeal stated that for the past two years regulators and the independent public accountant had accepted the bank's methodology without criticism. Based on these comments, management determined that the comment in the ROE indicating the bank does not use qualitative factors was incorrect. The ombudsman's review of the work papers determined that the supervisory office adjustments focused on two portfolios that experienced 22 percent growth and were planned for additional 50 percent growth going forward. ROE comments did not clearly reflect the concern with the limited use of qualitative factors to determine the adequacy of the ALLL.

Inaccurate and Manipulation of Financial Statements

The appeal stated that the ROE comments regarding material errors in financial statement spreads were incorrect. The ROE recommended the establishment of quality control over the accuracy of financial statement spreads. It also stated that loan review had found material errors in approximately 25 percent of cash flow statements. The appeal states that the bank uses a computer-generated spread package that is not changeable by the credit analysts; however, errors have been made in the manual conversion from the standardized spread information into a proprietary risk screening tool. Management and the board were aware of these errors. While the ombudsman concluded that the statement on the accuracy of the financial statement spreads was incorrect, the issue of making decisions on erroneous financial information is cause for concern.

Repeat Matters Requiring Board Attention

The appeal also noted that the OCC examination team listed matters requiring board attention (MRBA) as repeat criticisms from the previous ROE. The board and management disagreed with this characterization and provided a listing of MRBA from both examinations to illustrate their posture on this issue. The board and management were correct in noting that there was only one repeat MRBA detailed in the examination being appealed; however, weaknesses were again identified in lending, which is the bank's most significant activity. The lending area had been the subject of MRBA in the last three ROEs.

New Product Development Process

One of the issues contained in the MRBA dealt with the bank's need to formalize a new product process. The appeal noted that at the time of the examination the bank was just beginning to underwrite its first live transaction in the new financing program and found it necessary to alter some procedures because the actual information was different than anticipated. The bank acknowledged their interest as an innovator and advocate for new products. They also maintained that there were no loans outstanding in any new product category and the highly critical focus by examination team to new products in the ROE was inappropriate.

The ability of management to respond to and address the risks that may arise from changing business conditions, or the initiation of new activities or products, is an important factor in determining the overall risk profile of the bank. This institution had a history of being innovative in developing new products. The ombudsman determined, while the bank had not booked any new products at the time of the examination, a *formalized* new product process, whether there was exposure booked or not, was a sound recommendation for this organization, given their appetite for product innovation.

Management Rating

Background

The appeal submission states that the board and management's practices and performance was not less than satisfactory given the nature of the bank's activities. The submission lists the following items as significant changes that have occurred since the last examination:

- Significant progress has been made in enhancing credit administration and controls;
- Successful execution of an initial public offering that trebled total capital in the bank; and
- The bank has demonstrated its ability to underwrite and service quality commercial loans by virtue of its success in capital market activities.

Discussion and Conclusion

The management rating is designed to reflect the quality of board and management supervision of the institution. Management practices differ depending on the size and complexity of the organization. Complex organizations require a stronger framework of systems and controls. Having gained an understanding of the complexity of the bank's activities and despite the size of the bank, the ombudsman determined activities in this institution required *formalized* systems and controls. Over the last three years, significant weaknesses in risk management systems and controls were detailed within ROEs. While management made significant progress in some areas, other areas lagged in implementation of appropriate processes to identify, measure, monitor, and control risks associated with the bank's activities. The ROE addressed several weaknesses in risk management systems associated with the bank's lending practices. The lending control weaknesses dealt with the lack of officer accountability for assigning risk rating and the volume of inaccurate risk ratings identified during the examination. The bank had a history of inaccurate officer ratings and lack of accountability.

OCC Bulletin 97–1, “Uniform Financial Institutions Rating System and Disclosure of Component Ratings” (January 3, 1997), reflects an increased emphasis on risk management processes, particularly in the management component. This bank’s management team had experienced significant successes, which were highlighted in the appeal. However, risk management processes had not been commensurate with the complexity of their activities or development of new products. At the time of the examination, risk management activities needed strengthening to ensure problems or significant risks were adequately identified, measured, monitored, and controlled. The ombudsman determined the assigned 3 management rating was appropriate given the concerns regarding risk management systems.

Composite Rating

Background

The appeal stated the bank’s composite rating was lowered from a 2 to a 3 rating, when the financial performance of the bank had strengthened. The bank provided a recap of financial indicators. At the last examination the bank’s assigned C/CAMELS ratings were 2/233222, while at the appealed examination they were 3/233122. The appeal submission stated the only change from the prior examination was an improvement in earnings and that the capital rating arguably could have been 1 rated. Bank management also commented that subsequent to the examination, but well in advance of the issuance of the ROE, a substantial amount of capital was downstreamed to the bank, increasing the leverage ratio. In the board and management’s opinion, the OCC should not have had any material supervisory concerns.

Discussion and Conclusion

The appeal, appropriately, discussed the financial performance of the institution. The strong capital base and level of earnings the bank generated certainly warrant consideration when assigning the composite rating. However, those areas by themselves are not the basis for determination of this rating. A composite rating should incorporate any factor that bears significantly on the overall condition and soundness of the institution. The ability of management to address the risks confronting an organization is an important factor in evaluating the overall risk profile and determining the level of supervisory attention. The board and management’s lack of diligence in effectively addressing risk control functions detailed in previous ROEs, within appropriate time frames, was again demonstrated with three of the four MRBA identified in the examination under appeal focusing on this issue. As discussed above, the risk management concerns regarding the bank’s lending activities have received specific attention in the last three ROEs. Left unchecked, these concerns have the potential to become more severe in an economic downturn, particularly because this bank’s target market is the manufacturing sector. Therefore, the ombudsman found the assigned 3 composite rating appropriate, considering weaknesses in the bank’s risk management systems.

CRA Appeal

Background

In the CRA appeal, the board and management stated that although they agree with the numerical analysis used to determine the CRA rating, the statistics are reasonable when the bank’s business strategy and performance context is taken into account. Further, based on dollar volume of credit extended within the bank’s assessment area, the bank has satisfactorily performed under the CRA regulations. The appeal noted the bank does not fit the profile of a typical community bank. It specializes in providing credit, trade, and depository services to small and medium size manufacturing companies located in the United States and several international emerging markets. The bank’s typical borrower is a privately owned and operated company with annual sales of $2–25 million, and has been in business for at least three years. The bank extensively uses government guaranteed loan programs and typically will sell either the entire loan or the guaranteed portion of the loan, while retaining servicing rights.

The bank accomplishes its business strategy through the operation of one full-service office and eight loan production offices (LPOs) throughout their geographic region of the country. In addition, the bank has contracts with 11 international agents located in the emerging markets of South America, Central America, Mexico, Middle East, Asia, South Pacific, and South Africa.

Discussion

Given the bank’s business strategy and performance context, the key issue in this appeal was if the bank had satisfactorily met the credit needs of its community. The facts involved in this appeal are not in dispute. The supervisory office did not dispute, and indeed used in its evaluation of the bank’s CRA efforts, the statistical analysis prepared by the bank’s CRA officer. The “needs to improve” rating was based on the determination that the bank “does not meet standards for satisfactory performance” for two assessment criteria—“Lending in Assessment Area” and “Lending to Borrowers of Different Incomes and to Businesses of Different Sizes.” Further, the “Loan to Deposit Ratio” and “Geographic Distribution of Loans” were found to “exceed the standards for satisfactory performance" and "meet the standards for satisfactory performance," respectively.

To reach a conclusion on this appeal, the ombudsman carefully considered the bank's business strategy and performance context to determine the impact on the bank's overall CRA assessment.

Performance Context

In evaluating a bank's CRA activities, a full understanding of the performance context in which it operates is necessary. The performance context considers the economic condition and demographics of the assessment area, competition, and the types of products and services offered by the bank. In the case of this bank's CRA evaluation, the performance context was an integral component of the ombudsman's analysis because of the unique business plan and product delivery systems employed by the bank. While the CRA activities of other similarly situated financial institutions are considered, bank-by-bank comparisons are not a component of the overall rating process.

Lending in Assessment Area

In general, an institution that does not originate more than 50 percent of its lending in its assessment area will not meet the standards for satisfactory performance. However, the significance of this factor may be mitigated when considering performance context issues such as competition, economic conditions, a bank's product line, or a bank's business strategy. In addition, when an institution has a high level of lending outside its assessment area because of the use of non-traditional product delivery systems, favorable consideration may be given for loans to low- and moderate-income persons and for small businesses and farm loans that are made outside the assessment area, provided the institution has adequately addressed the needs of its assessment area.

During the CRA evaluation period, the bank originated 16 percent of its loans within its assessment area and 84 percent of its loans outside its assessment area. In addition, only 22 percent of the total number of loans originated during the evaluation period were made within the bank's assessment area. The bank's business strategy of selling either whole loans or the guaranteed portion of loans allowed it to provide significantly more small business credit than it could using a more traditional approach. This strategy enabled a $200 million dollar bank to originate almost $500 million in loans during the two-year evaluation period. In terms of total small business lending, as reported to the Federal Financial Institutions Examination Council, the bank compares favorably to two large banks in the area and to the average per bank data. In 1996, the average reporting bank in the state originated $12 million in small business loans, while this bank originated more than $37 million.

While lending in the bank's assessment area in dollar terms is favorable, the ratio of total lending inside versus outside of the assessment area is less than 50 percent. However, it is clear that the loans made outside of the assessment area through the LPOs are consistent with the bank's business strategy. Even though lending in the bank's assessment area technically does not meet the standards for satisfactory performance, this factor should not negatively affect the evaluation of the bank's overall CRA performance. Therefore, while the ombudsman did not change the conclusion for this factor, it was determined that the impact of not meeting this standard should be mitigated on the overall CRA evaluation when the performance context is considered.

Lending to Borrowers of Different Incomes and to Businesses of Different Sizes

Under the small bank CRA procedures, commercial lending performance is evaluated based on the number and volume of loans to businesses of different sizes. Loans made to businesses with revenues less than $1 million are considered small business loans under the CRA regulation. When sufficient data is not available to analyze these assessment criteria, examiners may consider loans that were less than $100 thousand when originated, as a proxy for business size.

During the CRA evaluation period, the bank originated 8 percent by dollar amount and 16 percent by number of the loans in the assessment area to businesses with gross annual revenues of less than $1 million. While approximately 39 percent of the average bank's small business loans are to businesses with gross annual revenues of less than $1 million, this bank only made 11 percent of its small business loans to such businesses. In addition, 14 percent of the small business loans the average bank originates are less than $100 thousand, compared with this bank's 5 percent.

Community contacts within the bank's assessment area identified the need for micro-loans and start-up loans to small business owners. By targeting borrowers with gross annual revenues between $2–25 million, the bank limited its ability to meet the credit needs of very small business owners. Strict adherence to the business strategy limits the bank's ability to meet these needs of their community.

Therefore, when considering all relevant facts and circumstances, the ombudsman concurred with the findings of the supervisory office that the bank does not meet the standards for satisfactory performance under this factor.

Conclusion

Based on the available data, the ombudsman concluded that the bank's CRA performance for the evaluation period was more reflective of a "satisfactory record of meeting the community's credit needs" than the assigned "needs to improve." While "Lending in the Assessment Area" did not meet the standards for satisfactory performance, the impact of this conclusion on the overall CRA rating was mitigated by the bank's business strategy, product line, and performance context issues. This coupled with the positive conclusions for the "Loan to Deposit Ratio" and the "Geographic Distribution of Loans" further supports an overall performance rating of "satisfactory record of meeting the community's credit needs." The rating for "Lending to Borrowers of Different Incomes and to Businesses of Different Sizes" remains unchanged.

Appeal 2—Appeal of Component and Composite Ratings and Report of Examination Conclusions (ROE) regarding the Internal Audit Process and the Custody Arrangement

Background

A national bank formally appealed the following:

- The Composite Uniform Financial Institutions rating of 3, and the conclusion that the overall condition of the bank was less than satisfactory.
- The ROE conclusions relating to capital adequacy, earnings, liquidity, sensitivity to market risk, and the internal audit process.
- The ROE conclusion that the level of supervision by management and the board was less than satisfactory, i.e., management rating.
- ROE conclusion pertaining to a certain custodial arrangement.

The appeal highlighted the bank's position on each of the individual component ratings, the internal audit process, the composite rating, and the custody arrangement. In this appeal summary, the discussion and conclusion on each of the appealed component ratings and internal audit issues will be discussed individually, followed by an overall discussion and conclusion on the composite rating and the custodial arrangement.

Discussion and Conclusion

Capital—Report of Examination Rating 3

The appeal stated that with its existing capital ratios the bank was "well-capitalized," yet the OCC concluded that capital was unsatisfactory. The appeal further stated that this was inappropriate because the OCC should have realized that the bank's capital position would improve in the coming months with planned reductions in certain exposures. According to the bank, the OCC seemed to base its conclusions on the bank's recent rate of asset growth and on comparisons with the bank's peers, not on the established regulatory benchmarks for measuring capital adequacy.

A financial institution is expected to maintain capital commensurate with the nature and extent of its risks and management's ability to identify, measure, monitor, and control these risks. The bank's risk profile increased primarily due to rapid asset growth and a large concentration of exposure in high-risk emerging countries. At the time of the examination, the bank's criticized assets doubled, earnings performance was only fair, and weaknesses were noted in the allowance for loan and lease losses (ALLL) methodology, loan administration, and operations. While the bank's capital and strategic plans called for continued growth, efforts to increase capital had not been successful. Although the bank met the prompt corrective action (PCA) benchmark ratios, there were significant qualitative factors that supported the need for additional capital. The capital posture did not fully support the bank's risk profile, even though the quantitative ratios exceeded the minimum statutory requirements. Therefore, the ombudsman concluded that the assigned 3 rating was appropriate at the time of the examination.

Management—ROE Rating 3

The appeal stated that the OCC's view that management and the board did not adequately supervise the bank was based on a faulty two-pronged analysis. First, it incorrectly assumed that the bank's overall condition was less than satisfactory. Secondly, it rested on two events that occurred at the bank, the increase in an emerging market exposure and a certain custodial arrangement. The appeal stated that neither of these events was indicative of lax supervision at the bank.

The management rating reflects the quality of board and management supervision of a bank. Management practices differ depending on the size and complexity of the organization. Risk management practices and controls should be commensurate with the bank's risk profile and complexity. The ability and willingness of management to respond to changing circumstances and to address risks that may arise from changing business conditions in a timely manner are important factors in determining the management rating. The ombudsman recognized the tenure and experience of the management team and the board; however, at the time of the examination, management had not implemented risk management processes to adequately identify, monitor, and control risk in key areas of the bank, such as capital, liquidity management, concentrations, and supervision of affiliate activities. The ombudsman concluded that at the time of the examination, the assigned 3 rating was appropriate.

Earnings—ROE Rating 3

The appeal indicated that earnings were stable and that, prior to agreeing to record an almost $2 million ALLL provision against 1997 earnings, the bank's return on equity would have been in excess of 13 percent and its return on assets would have been 0.68 percent.

Pursuant to OCC Bulletin 97–1, "Uniform Financial Institutions Rating System and Disclosure of Component Ratings," the earnings rating reflects not only the quantity and trend of earnings, but also factors in events that may affect the sustainability or quality of earnings. Earnings should be sufficient to support operations and to provide for the accretion of capital and adequate provisions to the ALLL. The bank's 1997 earnings performance was sufficient to support operations and the ALLL, but capital augmentation was minimal considering the bank's growth. Trends noted in lower asset yields, higher deposit costs, and increased provisions were factored into the analysis. Based on this, the ombudsman concluded that a 3 rating was appropriate, at the time of the examination.

Liquidity—ROE Rating 3

The appeal indicated that the OCC's 3 rating was based on a set of contingencies that are highly unlikely to occur. The bank does not believe that they are at risk of losing their ability to attract brokered deposits, its principal source of funding. The appeal also stated that the bank has access to substantial sources of stable capital that could and would be used if its ability to accept brokered deposits were in jeopardy.

The bank has high liquidity risk based on its capital position and the increased risk resulting from the bank's exposure in some of their emerging markets portfolios. In addition, the bank did not have an adequate contingency funding plan should its eligibility for brokered deposits become jeopardized. Based on these factors, the ombudsman determined that a 3 rating appropriately reflected the bank's liquidity posture at the time of the examination.

Sensitivity to Market Risk—ROE Rating 3

The appeal stated that the 3 rating was assigned solely on the basis of a certain foreign country exposure. The ROE stated that interest rate and foreign exchange risks were considered low at the time of the examination and that the rating was assigned based on the foreign country exposure. The ombudsman concluded that a 2 rating was more reflective of the condition of this area, at the time of the examination rather than the assigned 3 rating.

Internal Audit Process

The appeal stated that the bank's internal audit process was considered less than satisfactory by the OCC because the audit schedule had not been completed and that the bank's audit committee had not met from late 1996 through mid-1997. The appeal also discussed a number of events occurring in early 1997 that adversely affected the internal audit function. The appeal stated that there were no negative repercussions in the bank during the period in which the events occurred.

While the ombudsman acknowledged the bank's arguments regarding the various audit function weaknesses noted in the ROE, there was need for improvement, particularly in light of the high operational risks noted in certain areas such as in Treasury. Although some weaknesses, individually, could have been mitigated by unplanned events that occurred during the examination, collectively they posed a concern that warranted management and the board's attention. OCC Bulletin 98–1, "Interagency Policy Statement on Internal Audit and Internal Audit Outsourcing" (January 7, 1998), states in part that "In discharging their responsibilities, directors and senior management should have reasonable assurance that the system of internal control prevents or detects inaccurate, incomplete or unauthorized transactions; deficiencies in the safeguarding of assets; unreliable financial and regulatory reporting; and deviations from laws, regulations, and the institution's policies. . . . Directors should be confident that the internal audit function meets the demands posed by the institution's current and planned activities."

Bank management indicated to the ombudsman that most of these audit deficiencies had been corrected subsequent to the examination.

Composite Rating (ROE Rating 3) and Summary

The bank's appellate submission stated that based on the bank's discussions of the component ratings, its overall condition during the period covered by this examination was not less than satisfactory. The appeal indicated that many of the conclusions in the ROE were reached with no factual or other evidentiary support. It further stated that the conclusions were inconsistent with the true condition of the bank and seemed designed to serve a justification for the 3 rating, rather than an accurate description of the bank's condition.

The OCC Bulletin 97–1, "Uniform Financial Institutions Rating System," states:

> Financial institutions . . . [rated 3] exhibit some degree of supervisory concern in one or more of the component areas. These financial institutions exhibit a combination of weaknesses that may range from moderate to severe. . . . Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. Financial institutions in this group generally are less capable of withstanding business fluctuations and are more vulnerable to outside influences than those institutions rated a composite 1 or 2. . . . Risk management practices may be less than satisfactory relative to the institution's size, complexity, and risk profile. These financial institutions require more than normal supervision which may include formal or informal enforcement actions. Failure appears unlikely, however, given the overall strength and financial capacity of these institutions. *[Fed. Reg.:* December 19, 1996, Vol. 61, No. 245, p. 67026]

At the time of the examination, the bank exhibited a significant degree of supervisory concern because of its rapid growth, increased exposure in particular emerging markets, and their impact on the bank's capital, earnings, and liquidity positions. Furthermore, the bank had not implemented risk management processes to adequately identify, monitor, and control risk in key areas of the bank, such as capital, liquidity management, concentrations, and supervision of affiliate activities. Based on this, the ombudsman determined that the 3 composite rating was reflective of the condition of the bank at the time of the examination. Additionally, these adverse trends and concerns continued through the processing of this appeal.

Custody Arrangement

The bank also appealed the OCC's conclusion that a custodial arrangement between the bank and its foreign affiliate constituted an unsafe and unsound banking practice and a violation of section 23B of the Federal Reserve Act, 12 USC 371c–1. The appeal states that while the custody arrangement with its affiliate could have been better documented and administered, it did not constitute an unsafe and unsound banking practice and did not result in a violation of law as noted in the ROE. The ombudsman reviewed this issue and carefully considered the points of discussion in the appeal and in the bank's outside counsel's letter.

Although banking is characterized by risk-taking, this arrangement reflected characteristics that were not prudent banking practices. For example:

- The bank's sole purpose for entering into an agreement was to inflate the affiliate's balance sheet.
- The bank participated in a repurchase agreement with little direct knowledge of the foreign country's central bank custody and control practices and had to rely on the counterparty for the expertise.
- The officer normally responsible for administering custody and similar arrangements was unaware of the agreement and related accounts.
- The board was not notified of this agreement, even though they had been previously served with civil money penalties for similar transactions.
- No one from the bank had signed the agreement.
- The bank did not maintain records or statements to track and report proceeds from any of the account transactions, other than original wires between the bank and its affiliate.

Furthermore, the ombudsman determined that the arrangement was not "on terms and under circumstances that in good faith would be offered to, or would apply to, nonaffiliated companies." Therefore, the ombudsman concluded that the custody arrangement was an unsafe and unsound practice and violated section 23B of the Federal Reserve Act, 12 U.S.C. 371c–1.

Appeal 3—Appeal of OCC's Interpretation of the Risk-Based Capital Treatment of Assigned Residual Interests in Asset Securitizations

Background

A bank formally appealed the OCC's interpretation of the risk-based capital treatment of assigned residual interests in asset securitizations. Specifically, the bank appealed the supervisory office decision that the assignment of a portion of the residual interest would not result in a lower capital charge for the bank on the recourse exposure created by those residuals.

The bank asserted that because the assigned residual interests share in the losses on the underlying loans sold into the securitization, the bank should be permitted to lower its total risk-weighted assets for risk-based capital purposes by a similar proportion. The bank further indicated that the transferred portions of the residuals creating the recourse obligation to third parties is structured in a manner that assures a pro-rata sharing of all risk and losses. In support of this contention, the bank refers to the glossary section of the March 1998 Call Report Instructions under the heading, "Sales of Assets for Risk-Based Capital Purposes" (p. A–72) (http://www.fdic.gov/banknews/callrept/crinst/398gloss.pdf). The instructions state the following:

> However, if the risk retained by the seller is limited to *some fixed percentage of any losses* that might be incurred and there are no other provisions resulting in retention of risk, either directly or indirectly, by the seller, the maximum amount of possible loss for which the selling bank is at risk (the stated percentage times the amount of assets to which the percentage applies) is subject to risk-based capital and reportable in Schedule RC–R and the remaining amount of the assets transferred would be treated as a sale that is not subject to the risk-based capital requirements. For example, a seller would treat a sale of $1,000,000 in assets, with a recourse provision that the seller and buyer proportionately share in losses incurred on a ten percent and 90 percent basis, and with no other retention of risk by the seller, as a $100,000 asset sale with recourse and a $900,000 sale not subject to risk-based capital.

Discussion

The OCC's interpretation was that the bank's assignment of a portion of its retained residual interest in securitization transactions should not result in a reduction of the bank's overall level of required capital. As a class, both the assigned and retained residual interests are wholly subordinate to the claims of certificate holders, and there is no pro-rata loss sharing with those senior interests. The bank has not sufficiently limited its losses to a fixed percentage of losses on the underlying loans. Consequently, the full amount of underlying loans are considered sold with recourse, and should be included in the bank's calculation of risk-weighted assets.

In order to appropriately resolve the issues identified in the appeal, it was essential that the ombudsman consider them in the context of on-going interagency capital policy deliberations and the resolution of similar issues with other institutions. An interagency working group was scheduled to review this issue at a meeting in March 1999.

Conclusion

Until such time as a joint interagency decision was reached on the underlying issues, the ombudsman opted to permit the bank to continue its current risk-based capital treatment. The bank's treatment reduced the capital requirement in proportion to the percentage of the residuals assigned to third parties.

The bank was to be informed when the agencies reached a final decision, and of any risk-based capital adjustments, which may be necessary.

Subsequent Event

The Federal Reserve Board, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the OCC reviewed this policy issue in March 1999, and reached a consensus that conforms to the OCC's original interpretation as conveyed to the bank. This consensus reaffirms that when a bank retains risk of credit loss in connection with a transfer of assets, those assets must be included in the bank's calculation of risk-weighted assets, subject to the low-level recourse rule. Notwithstanding the assignment of a portion of a residual interest in a securitization, the retained residual interest continues to give rise to a concentration of credit risk, relative to the underlying pool, for which the recourse capital requirement remains appropriate.

Consequently, for each pool of securitized loans, the banks should hold risk-based capital equal to the lesser of (a) 8 percent of the risk weighted amounts of the outstanding loans in the pool, or (b) the bank's maximum loss in the event the entire pool of loans defaulted. For this purpose, the bank's maximum loss exposure includes the book value (determined under GAAP) of any interest it holds in the pool, as well as any contractual obligation to reimburse the pool or investors for losses in the pool. If the bank's maximum loss exposure exceeds 8 percent of a pool's risk-weighted assets, the full amount of the underlying loans are considered sold with recourse and should be included in the bank's calculation of risk-weighted assets. However, should the bank's maximum loss exposure fall below 8 percent of the risk-weighted amount of the outstanding loan balances in the pool, the position would be eligible for more advantageous treatment under the low-level recourse rule.

The bank was informed of this decision.

Appeal 4—Appeal of Denial of *de Novo* Charter

Background

An organizing group appealed the decision of the Office of the Comptroller of the Currency's (OCC's) licensing division, Bank Organization Structure (BOS), to deny their application to establish a *de novo* chartered bank.

The organizing group expressed concern and disagreement with several reasons provided in the denial letter as the basis for denying the charter application. The group's appeal primarily focused on:

1. Inconsistencies in what they were told during the field investigation and what the denial letter stated;
2. Concerns expressed in the denial letter with the organizing group's lack of banking experience;
3. OCC concerns with the proposed bank's operating plan;
4. OCC comments about the proposed president/chief operating officer (CEO); and
5. Comments in the denial letter that indicate the group had not provided information on their plans to market the proposed bank's stock.

Discussion

While all concerns in the appeal were investigated and discussed with the appropriate parties, the ombudsman decided that opining on the propriety of the comments presented in the denial letter would not lead to a decision on whether a charter should be granted. The ombudsman determined the best approach to resolve this appeal would be to independently assess the information in the BOS application file and make a determination on the merits of the information as to whether the charter should be granted.

After reviewing the information, the ombudsman applied the criteria outlined in the regulation established for the purpose of providing guidance on granting bank charters to organizers of a proposed bank. 12 CFR 5.20, "Organizing a bank," is explicit in outlining the importance of the operating plan on the OCC's decision to grant a national charter. Specifically:

> (h) *Operating plan*—(1) *General.* (i) Organizers of a proposed national bank shall submit an operating plan that adequately addresses the statutory and policy considerations set forth in paragraphs (e) and (f)(2) of this section. The plan must reflect sound banking principles and demonstrate realistic assessment of risk in light of economic and competitive conditions in the market to be served.
>
> (ii) The OCC may offset deficiencies in one factor by strengths in one or more other factors. However, deficiencies in some factors, such as unrealistic earnings prospects, may have a negative influence on the evaluation of other factors, such as capital adequacy, or may be serious enough by themselves to result in denial. The OCC considers inadequacies in an operating plan to reflect negatively on the organizing group's ability to operate a successful bank. [12 CFR 5.20(h)]

The group's operating plan contained inconsistencies and assumptions that were not adequately explained. As an example, it was difficult to understand how the proposed institution would achieve deposit growth of 4 percent per year when the entire market had only experienced average growth of 1 percent in the four years presented in their deposit analysis. Additionally, a market penetration strategy that assumed the bank could pay less than market rate on deposits, when other banking professionals interviewed indicated deposits in that area were rate sensitive, did not appear realistic.

Conclusion

While the group was convinced that there was a need for a locally owned bank, they did not submit an operating plan that demonstrated the proposed bank could reasonably be expected to achieve and maintain profitability. The other issues discussed in the denial letter by themselves were not insurmountable had the operating plan been sound. While those issues did not form the basis for the ombudsman's decision, they offered no support to warrant granting a charter to the organizing group. In considering whether any factors were present to mitigate the weaknesses in the operating plan, the ombudsman determined there were no other factors to offset weaknesses of the plan. Therefore, the ombudsman upheld the denial of the charter, based on the poor operating plan.

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Statement required by 12 USC 250: The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Introduction

Mr. Chairman, thank you for the opportunity to appear before you today to discuss H.R. 10, the "Financial Services Act of 1999." Virtually everyone agrees that the laws that currently prohibit affiliations among banks and other financial services providers and limit the ability of banking organizations to diversify their financial activities are archaic. Changing these laws in ways that promote increased competition, greater efficiency, and more effective delivery of financial products to consumers will strengthen U.S. financial services firms and benefit their customers.

Financial modernization is both a political process and the process of innovation in a competitive marketplace. Every day, financial services firms evolve and adapt to serve the changing needs of their customers. Technological advances and the development of new financial products and services have increasingly blurred the old lines that once separated the offerings of banks, securities firms, and insurance companies. As a result, consumers of financial services now have a greater choice of financial services and products, at more competitive prices.

An important goal of financial modernization legislation should be to ensure that the government does not impede or frustrate the process taking place in the marketplace. Of course, some constraints are necessary to ensure that the interests of consumers are properly protected, and that important governmental interests are safeguarded. But legislation that is crafted to preserve competitive advantages for particular interests, to discriminate against any segment of the industry, or to limit the choices financial firms have for organizing their businesses for no compelling or clearly demonstrable public policy purpose retards the real and dynamic financial modernization already occurring in the marketplace. Even more significantly, legislation that will diminish the safety and soundness of our insured financial institutions should not be enacted under the guise of "financial modernization." I am greatly concerned that some aspects of H.R. 10 may have this effect.

In my testimony today, I will discuss why I believe that financial modernization legislation should be pursued in a form that will not interfere with the free operation of financial markets, except to the degree necessary to protect fundamental and clearly demonstrable government interests such as promoting the safety and soundness of our financial system and safeguarding the interests of consumers. I will then broadly address the provisions of H.R. 10 that relate to bank organizational structure, insurance activities, and consumer protection issues. I am attaching to my testimony a more detailed analysis of the bill's provisions and the Office of the Comptroller of the Currency's (OCC) views on the major issues it presents. My testimony will highlight some areas we support and those that concern us.

Modernization Has Been Occurring in Financial Markets

Federal laws restricting bank geographic and product diversification date back nearly 70 years. Although many restrictions have been removed, allowing banks to become more efficient and competitive, significant constraints still exist. Geographic restrictions on bank location were dramatically reduced when the Riegle–Neal Interstate Banking and Branching Efficiency Act was passed in 1994. However, other laws restricting the activities of banking organizations remain, most notably, the Glass–Steagall Act of 1933, which was intended to separate commercial banking from investment banking, and provisions of the Bank Holding Company Act that confine the ability of corporations owning banks to diversify into other financial activities.

It has become clear in recent years that these constraints segregating various sectors of the financial marketplace have outlived their usefulness. The financial services marketplace has undergone enormous changes. Banks, securities firms, and insurance companies increasingly offer a similar array of products and services. Regulatory and judicial rulings continue to erode many of the barriers separating the different segments of the financial services industry. In short, technological and financial innovation, together with market pressures to offer consumers a wider array of services, are breaking down the traditional segmentation of the financial services marketplace.

While many financial service providers have been able to respond to these competitive forces without legislation, there is a strong case that the time has come for Congress to unambiguously undo antiquated constraints that exist in current law and bring the statutory framework into line with the realities and needs of the marketplace. I respectfully regret to say, however, that many of the provisions in the current version of H.R. 10 impose new and needless constraints on banks, particularly our nation's community banks, and will not permit them to innovate and compete in the most efficient manner. Those provisions will have significant adverse effects on the long-term safety and soundness of our banking system.

Ability to Diversify Products and Services is Essential to Banks' Safety and Soundness

Preservation of the safety and soundness of the banking system is a fundamental government interest and a pivotal consideration in any financial modernization legislation. For this reason, we have supported the inclusion of strong safety and soundness provisions, such as the requirement that all of the banks in a holding company be well capitalized and well managed, as a precondition for engaging in expanded activities. But protecting the safety and soundness of banking institutions involves more than simply writing safeguards against loss into the law. Providing banks the opportunity to maintain strong and diversified earnings through a range of prudently conducted financial activities is an equally critical component of safety and soundness.

Historically, banks have been heavily dependent on net interest margins—traditional lending—as a source of earnings. This makes banks particularly vulnerable to changes in economic conditions. During the 1990s, the net interest income of commercial banks has declined—both as a percentage of assets and as a percentage of net operating revenue—and the growth in the volume of lending activity due to the strong economy has been offset by significant compression in bank net interest margins. At the same time, however, banks have been able to preserve or enhance their profitability through growth in non-interest income. In the last 10 years alone, non-interest income has increased from approximately 30 percent of net operating revenue to 39 percent. Non-interest income consists primarily of fees, service charges, commissions, and the performance of data processing services for others and is equally critical to large and small institutions trying to enhance and vary their income streams. Thus, banks' long-term stability and viability will be affected by whether they are allowed to continue to pursue financial activities that produce non-interest income to counterbalance the likely continued reduction in earnings from interest-bearing assets.

Banks can seek additional earnings sources by providing new products and services or moving into new geographic markets; or they can improve earnings by reducing their operating costs or increasing their risk profile in their lines of business. The OCC and other financial institution regulators have increasingly expressed concern about banks taking on additional credit risks to achieve high earnings targets, particularly given the slowdown in global economic activity and the likelihood of stresses in regional economies. Evidence over the past year showing deterioration in the quality of loan underwriting standards for commercial and industrial loans has been a particular source of worry.

Product, geographic, and income diversification all contribute importantly to bank safety and soundness. Many different factors have been responsible for the waves of bank failures that have characterized various periods of our financial history. However, one consistent factor has been excessive *concentrations*—geographic concentrations or concentrations in one or another type of *lending*. The high rate of bank failures in the 1920s was largely confined to small agricultural banks that lacked diversification with respect to either geography or lines of business. In the early 1980s, banks that had excessive concentrations of loans in the oil business and/or in the southwestern region of the United States failed in large numbers. Many of the banks that failed in the years 1984–1986, when agricultural land prices fell more than 40 percent from their 1981 peak, also appear to have suffered from an inability to diversify. And, finally, in the late 1980s and early 1990s, bank failures throughout the world were associated with excessive real estate lending.

Ideally, of course, bank regulators could anticipate what geographic areas and product lines would be associated with future loan losses and would use their powers of persuasion to prevent banks from developing heavy exposures in lending to those areas. Given the impossibility of perfectly foreseeing the future regarding the nature and location of lending problems, however, the prudential strategy of diversification reduces the vulnerability of banks to unexpected losses from lending, wherever they may occur.

A wealth of empirical research demonstrates that diversification is critically important to maintaining a strong banking system. Firms with diversified assets and revenue streams can better withstand economic shocks during the business cycle, whereas firms limited by geographic or product restrictions can be affected more seriously by downturns. Diversification can enable banks to increase their average rate of return for any given volatility of return, or to reduce the volatility of earnings for any average level of return, in either case reducing their probability of failure.[1]

The business of banking revolves around risk management, and banks have demonstrated they can effectively manage a variety of risks. Banks already manage complex risks, such as those associated with derivatives and other off-balance sheet activities—risks that are similar to those presented by new financial activities, such as insurance. The effect of H.R. 10, which forces banks to remain primarily intermediaries of credit risk, is to make them inherently more exposed to risk than institutions with diversified sources of income. When bank activities are restricted, risk exposures are correspondingly concentrated, and the banking system as a whole is more vulnerable to economic shocks.

Operating Subsidiaries Will Strengthen Banks and Enhance Safety and Soundness

Financial modernization legislation should not artificially restrict the ability of financial services providers to choose, consistent with safety and soundness, the most efficient way to conduct their business. There is no a priori governmental interest in restricting organizational choice, and with appropriate safeguards, expanded activities may be conducted safely and soundly in either a bank subsidiary or a bank affiliate.

The current version of H.R. 10 mandates that banking organizations wishing to diversify into new activities as principal do so only through bank holding company affiliates—a "one-size-fits-all" approach that needlessly denies firms the choice of expanding through a bank subsidiary structure. This restrictive approach undermines, rather than enhances, safety and soundness. It will inevitably force resources out of banks and diminish the protections for the federal deposit insurance fund.

Consider the business decision facing a banking organization that may want to take advantage of a newly legislated opportunity to expand into insurance or securities activities. If the only organizational choice available is the holding company affiliate, it is highly likely that resources of the bank will be drawn down to capitalize and fund the new activity. The bank will upstream dividends to its parent either to inject capital into the new affiliate, or to support new holding company debt or equity issued for that purpose. The bank itself will reap no financial benefit from the new activity. In fact, since many of the business opportunities of the new affiliate may be generated by the day-to-day business of the bank, the bank will be deprived of profit opportunities that would rightfully belong to and be captured by it if the operating subsidiary format had been permitted.

By contrast, if the new activity could be positioned in a subsidiary of the bank, any capital or funding provided by the bank would remain as part of the bank's consolidated resources. In addition, banks would be able to capture directly the benefits of new business opportunities that may be closely related to, or generated by, their normal day-to-day banking activities. Income flows resulting from such new activities would flow directly to the bank, would not be diverted to the holding company, and would provide the bank with a diversified source of earnings. And, as the Federal Deposit Insurance Corporation (FDIC) has repeatedly testified, in the event that a bank should itself suffer financial difficulties, earnings from bank subsidiaries can compensate for a downturn in bank profits, and, in the event of bank failure, the existence of such subsidiaries can significantly reduce the losses of the federal deposit insurance fund.

There is also clear evidence that banking organizations can benefit from engaging in expanded financial activities through bank subsidiaries without creating undue safety and soundness concerns. For example, the Federal Reserve Board has long permitted U.S. banking organizations to engage in securities activities overseas through foreign subsidiaries. At year-end 1997, U.S. banking organizations operated 100 direct and indirect bank securities subsidiaries, a high proportion of which (88 percent) were profitable, with aggregate net income of $732.3 million.[2]

This comparison also highlights the discriminatory nature of the structural restraints H.R. 10 imposes on U.S.

[1] For a review of the literature, see Mote, Larry R., "The Separation of Banking and Commerce," *Emerging Challenges for the International Services Industry,* JAI Press, 1992, pp. 211–17, and Whalen, Gary, *Bank Organizational Form and the Risks of Expanded Activities,* Economics Working Paper 97–1, January 1997, pp. 5–12.

[2] At year-end 1997, these 100 direct and indirect bank securities subsidiaries had aggregate total assets of $249.5 billion. They represented 90.9 percent of the total number of overseas securities subsidiaries and accounted for more than 98 percent of the total assets in all foreign securities subsidiaries. The average aggregate rate of return on assets for bank securities subsidiaries over the 1987–1997 period was around 60 basis points, roughly three times higher than the comparable figure for holding company securities subsidiaries. See Whalen, Gary, *The Securities Activities of the Foreign Subsidiaries of U.S. Banks: Evidence on Risks and Returns*, Economics Working Paper 98–2, February 1998.

banks as compared to foreign banks. Under H.R. 10, U.S. banks could have subsidiaries—operating abroad—that conduct an expanded range of financial activities. But a *U.S.* bank's domestic subsidiary cannot engage in the activities that are permissible for that bank's foreign subsidiary. Also, a *foreign* bank may engage in nonbanking activities in the United States, including securities underwriting, through a direct subsidiary of the bank. But a *U.S.* bank could not have a *U.S.* subsidiary that engages in the same range of activities permitted for a *foreign* bank's *U.S.* subsidiary. Thus, U.S. law would allow a foreign bank to use the structure it determines most efficient for the delivery of products and services in the United States, while U.S. banks would be restricted to a single format. This result cannot be rationalized.

In addition, H.R. 10 uniquely discriminates against national banks relative to *state* banks by retaining or imposing burdensome statutory requirements that are not imposed on state banks. For example, national bank subsidiaries are flatly barred from engaging as principal in expanded financial activities; state banks are subject to no such comprehensive bar. Further, although the bill requires that all of a national bank's depository institution affiliates be well capitalized and well managed in order for the national bank's subsidiary to conduct new *agency* activities, no similar requirements are imposed on either state banks or thrifts engaged in the same activities through subsidiaries. And national bank subsidiaries, in addition to being limited to expanded financial activities conducted on an *agency* basis, are further limited to conducting those new agency activities *only* through a *wholly owned* subsidiary. Thus, national banks, but not state banks, are deprived of the ability to use joint ventures or consortiums of banks to engage in new agency activities. This type of outright discrimination in the treatment of national banks embedded in H.R. 10 is simply impossible to justify on any principled basis.

Moreover, the approach embodied in H.R. 10, which would force resources out of banks, is contrary to the interests of the federal deposit insurance fund. FDIC Chairman Donna Tanoue and former FDIC chairs have consistently pointed out that the subsidiary format provides better protection for the deposit insurance fund. Last September, in a joint article in the *American Banker*, former chairmen Helfer, Isaac, and Seidman stated their position clearly: "Requiring that bank-related activities be conducted in holding company affiliates will place insured banks in the worst possible position. They will be exposed to the risk of the affiliates' failure without reaping the benefits of the affiliates' successes."[3]

In her testimony before the Senate Banking Committee last June, Chairman Tanoue stated that "the subsidiary structure can provide superior safety and soundness protection."[4] In 1997, former Chairman Helfer noted in her testimony that, "[w]ith appropriate safeguards, having earnings from new activities in bank subsidiaries lowers the probability of failure and thus provides greater protection for the insurance fund than having the earnings from new activities in bank holding company affiliates. The reason for this is that diversification often leads to less volatile earnings. . . . Thus, on average, allowing a bank to put new activities in a bank subsidiary lowers the probability of failure and provides greater protection to the insurance funds."[5]

One could argue, then, that from the perspective of prudent bank supervision and the interests of the deposit insurance fund, the *only* format that should be used for expanded activities is the operating subsidiary. But individual banking organizations may have particular reasons, based on their business, why the use of a holding company affiliate is more effective for them, and a prescriptive approach would be inconsistent with the basic principle I discussed earlier—that restrictions on organizational format should not be imposed except where unavoidably needed to protect clearly defined governmental interests. To forbid the operating subsidiary format, however, is not only flatly inconsistent with that principle, but positively inimical to well-defined governmental interests. The responsible approach is to allow institutions the freedom to choose the organizational structure that best suits their needs, subject—in either case—to the imposition of solid financial protections for insured banks.

Promoting Full and Fair Competition in Insurance Markets Benefits Consumers

Financial modernization legislation should nurture innovation in the marketplace so that consumers have better access to a greater variety of financial products and services at more competitive prices. To that end, any new law should maximize business opportunities for all market participants by eliminating archaic or protectionist restraints on the delivery of products and services. In the insurance area, H.R. 10 does not

[3] "Ex-FDIC Chiefs Unanimously Favor the Op-Sub Structure," *American Banker*, September 2, 1998.

[4] See testimony of Donna Tanoue, Chairman, FDIC, on financial modernization before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, June 25, 1998.

[5] See testimony of Ricki Helfer, Chairman, FDIC, on financial modernization before the Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises, Committee on Banking and Financial Services, U.S. House of Representatives, March 5, 1997.

achieve that result. Instead, it hobbles banks that want to sell insurance by undercutting the Supreme Court's decision in the *Barnett* case and sanctioning discriminatory state insurance sales laws.

The *Barnett* case applied well-recognized judicial standards of preemption to states' efforts to curtail the "broad permission" that national banks have to sell insurance under the federal statute that authorizes national bank insurance sales. H.R. 10 would replace the law and precedents as they stand today with a virtually indecipherable combination of:

1) not one, but several new preemption standards to apply to different types of insurance activities;
2) "safe harbors" of unclear scope that allow the states to impose discriminatory restrictions on bank insurance activities free from *any* preemption by federal law;
3) new definitions and redefinitions of insurance products that will tell if a bank can even provide an insurance product *at all;*
4) a new standard for judicial review of issues that arise under these new standards;
5) *differences* in preemption standards applicable depending upon *when* a particular state's provision was adopted; and
6) the astonishing prospect that in each state, banks selling insurance could be subject to a different combination of some or all of the insurance sales customer protection regulations required to be promulgated by the federal banking agencies and state provisions that, in a given state, would sometimes co-exist with, sometimes supercede, and sometimes would be superceded by particular provisions of those federal rules.

For example, the bill lists 13 "safe harbor" areas in which the states may legislate or impose regulations or restrictions on banking organizations selling insurance that would not apply to nonbank competitors, and do so free from any federal constraints. In these 13 areas—which include important aspects of insurance sales such as licensing requirements, disclosures, and advertising—*any* state may write rules for banks and companies affiliated with banks that are more onerous than those for any other insurance provider. Those state rules may be written (as some state rules have been) in ways that unreasonably disadvantage banks and bank affiliates relative to other insurance providers. Indeed, even if the purpose of such rules were to provide a competitive advantage to nonbank competitors—which would almost certainly be their effect—they would still be protected. Any state provision that fits within one of these "safe harbors" would be immune from challenge despite such discrimination, and even if—contrary to the *Barnett* standard—it prevented or significantly interfered with the authority of national banks to sell insurance.

The OCC does not seek to be an insurance regulator and supports the role of state insurance regulators in the supervision of insurance activities conducted by banks, their subsidiaries, and their affiliates. Since the *Barnett* decision was handed down, the OCC has tried to work constructively with state insurance regulators to resolve issues where state provisions affected national banks in a manner contrary to the principles of the *Barnett* decision. In those very few cases where differences of opinion were litigated, the courts had clear and time-tested standards of preemption that they used to resolve the questions presented.

The tangle of insurance provisions in H.R. 10 is most likely to produce new rounds of litigation in several areas, under untested new standards. These provisions are not necessary to ensure that adequate customer protections exist for bank insurance sales and actually retard the development of new products and delivery channels that could benefit customers.

Moreover, it is clear that H.R. 10 does not modernize the ability of national banks in particular to participate in the insurance sales market, nor does it promote parity with their state-chartered competitors. The federal statute that the Supreme Court reviewed in *Barnett* authorizes national bank insurance sales only in places with 5,000 or fewer inhabitants. H.R. 10 leaves this restriction in place even though it is just as outdated as the Glass–Steagall provisions that the bill would repeal. Moreover, at least 17 states permit bank-direct insurance sales in state-chartered banks free from any similar geographic limitation.[6] After enactment of H.R. 10, then, national banks will continue to be subject to an outdated constraint on their ability to compete in insurance markets.

The insurance provisions in H.R. 10 perpetuate an approach to financial services legislation that attempts to segment markets and retain competitive advantages for favored groups. They retard, rather than encourage, competitive and marketplace developments and thus they fail the key test for financial modernization legislation.

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[6] See Conference of State Bank Supervisors, *A Profile of State Chartered Banking*, (16th edition, 1996).

Ensuring Adequate Consumer Protection is an Essential Component of Financial Modernization

Financial modernization legislation also must ensure that the interests of consumers are appropriately protected through adequate disclosure mechanisms and the deterrence of deceptive sales practices. The federal banking agencies have worked together to advise depository institutions to conduct retail sales in a safe and sound manner that protects the interests of consumers. It is not only appropriate but essential for the government to foster an environment in which consumers can evaluate the relative riskiness of their financial choices based on a fair understanding of the products and services available to them.[7] But to do this, the standards expected of banks need to be clear and workable. The scheme of insurance customer regulations that would be applied under H.R. 10 is neither.

Finally, it is important to note that technological advances and the emergence of diversified financial services companies have also raised significant issues regarding the proper handling and safeguarding of customer financial information and the protection of consumer privacy. The financial services industry has many years of experience in handling that information and protecting their privacy. As banks affiliate with other financial services providers, and share an increasing amount of confidential customer information, it is imperative that regulators have the ability to ensure compliance with existing privacy laws that govern the handling of customer information. It is for this reason that we urge that the bank regulators' examination authority under the Fair Credit Reporting Act be restored.

Conclusion

In conclusion, let me again emphasize the importance of limiting intervention in financial markets to that which is necessary to protect clearly defined, demonstrable governmental interests, such as maintaining the safety and soundness of the banking system and ensuring that consumers are adequately protected. Our concerns over the current version of H.R. 10 arise from the inclusion of provisions that diminish safety and soundness and fail to remove existing barriers to product diversification and competition, and thus do not meet the essential requirements of true financial modernization.

[Attachment follows]

[7] The OCC's "Guidance to national banks on insurance and annuity sales activities," issued on October 8, 1996, [OCC Advisory Letter AL 96–8] ("advisory") instructs banks to follow proper procedures to ensure customers are able to distinguish between insurance and deposit products. These procedures include making adequate disclosures that an insurance product is not FDIC insured, is not a deposit or an obligation of the bank, and is not guaranteed by the bank. Moreover, the OCC's advisory emphasizes that banks need to ensure that only qualified people are selling insurance, and that insurance is sold in areas that are separate from traditional banking functions, *e.g.*, deposit taking, to the extent practicable.

Attachment

The OCC's Primary Concerns about H.R. 10, "The Financial Services Act of 1999," Introduced January 6, 1999 (February 12, 1999)

Contents

1. Disparagement of the National Bank Charter
2. Subsidiaries of Banks
3. Bank Insurance Activities
    - A. Insurance Sales Activities/Preemption
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    - D. Other Issues
4. Bank Securities Activities
5. Bank Supervision
6. Consumer Protections
7. Community Reinvestment Act
8. Privacy of Bank Customers
9. National Wholesale Financial Institutions

1. Disparagement of the National Bank Charter

As discussed in greater detail below, provisions throughout H.R. 10 uniquely disadvantage national banks. The cumulative effect of these provisions is to undermine significantly the national bank charter, which is held by the preponderance of the nation's large and internationally active banks, hundreds of regional banks, and by more than 2,500 community banks. A basic principle of financial modernization legislation should be to ensure that new laws do not interfere with the free operation of financial markets, except to the extent necessary to protect fundamental and clearly defined governmental interests, such as safety and soundness and safeguarding the interests of consumers. Contrary to this basic principle, including safety and soundness, under H.R. 10, national banks would be subject to artificial, unnecessary, and costly restrictions that deprive them of the benefits of increased earnings and product diversification that the bill is intended to promote.

Specific Concerns

- *National banks are deprived of flexibility in structuring their business operations.* Under section 121, national banks are generally not permitted to use subsidiaries to offer expanded products as principal. Yet, foreign banks are permitted to have direct subsidiaries in the United States that engage in a full range of new financial activities, including underwriting securities. Nearly 40 percent of the so-called "section 20 affiliates" permitted to underwrite and deal in bank impermissible securities in the United States today are, in fact, *subsidiaries* of *foreign* banks.

- *National bank subsidiaries offering products as an agent are subject to burdensome statutory requirements that are not imposed on state banks.* Section 121 applies restrictions to national banks conducting new agency activities through subsidiaries that are not applied to other depository institutions engaged in the same activities through subsidiaries.

- *The* Barnett *case is undercut.* The Supreme Court's decision in *Barnett Bank* v. *Nelson* is overturned and replaced with the new preemption standards in section 104. That decision relied on preemption principles well recognized by the courts and found that certain state insurance sales restrictions were preempted for national banks. The new preemption standards in H.R. 10 will permit states to discriminate against banks and their subsidiaries and affiliates in the sales of insurance. The new, complex, confusing, and untested preemption standards will generate needless litigation and represent a step back from current law.

- *National banks continue to be subject to the "place of 5,000" rule in selling insurance.* No such restriction is applied to state banks. In fact, many states permit their banks to sell insurance anywhere.

- *OCC deference is eliminated for insurance.* The Supreme Court has consistently held that federal agencies should be given deference for reasonable interpretations of the laws they administer. This long-standing and well-established principle is eliminated under section 306(e) for OCC determinations relating to national bank insurance activities. As a result, national banks will not be able to rely on OCC decisions and will be faced with increased business uncertainty and litigation risks.

- *National banks lose the authority to conduct safe and sound activities that are permissible today.* Banks and their subsidiaries cannot offer new insurance products as principal after January 1, 1997. Offering annuities as principal is flatly prohibited. National banks' title insurance underwriting is severely restricted. Many currently permissible securities activities, such as certain asset-backed securities transactions, are pushed out of the bank and into an affiliate.

- *National banks are subject to increased regulatory burdens.* The bill gives the Federal Reserve Board (rather than the OCC in the case of national banks) the authority to determine whether a bank is well capitalized if the bank is part of a bank holding company engaging in the new financial activities. The Board also has the authority under certain conditions to impose other restrictions on national banks, *e.g.,* restrictions on transactions with nonbank affiliates (except subsidiaries of the bank). This subjects national banks to two different federal regulators implementing federal capital and operational standards.

2. Subsidiaries of Banks

Section 103 permits bank holding company affiliates to engage in a broad range of financial activities, including securities and insurance underwriting. However, under section 121, national bank operating subsidiaries may engage "solely as agent" in new financial activities that are impermissible for the parent bank to conduct directly, and even then, may do so only through *wholly owned* subsidiaries. Subsidiaries of national and state banks, as well as subsidiaries of thrifts, are expressly prohibited from engaging in new securities underwriting activities after September 15, 1997. Moreover, section 304 prohibits national (and state) banks and their subsidiaries from producing any new insurance products after January 1, 1997. Foreign banks are NOT subject to these prohibitions and, under the bill, may have direct subsidiaries in the United States that engage in securities and insurance underwriting activities, as well as all other financial activities.

In addition, section 121 subjects transactions between a national bank and its subsidiary engaging in the new *agency* activities—but not transactions between state banks or thrifts and their subsidiaries engaged in the same activities—to the operational requirements in section 23B of the Federal Reserve Act. Further, the new agency activities may be conducted in a subsidiary of a national bank only if all of its depository institution affiliates are well capitalized and well managed and satisfy other requirements. None of these requirements or restrictions are imposed on state banks or thrifts engaged in the same agency activities through subsidiaries.

Specific Concerns

To compete effectively with other financial services providers, banks cannot be hobbled by provisions that unnecessarily restrict their options, flexibility, and efficiency. In some cases, it may be preferable for a bank to conduct activities through a subsidiary and, in other instances, through a holding company affiliate structure. Banks should be free to make these business decisions for themselves without government mandates. Without appropriate organizational flexibility, banks will be less safe and less sound, offer fewer choices to customers, and be less able to serve the financial needs of the their communities and customers.

Safety and soundness benefits. With appropriate safeguards in place, the operating subsidiary structure is *more* safe and more sound than the affiliate structure.

- First, income from an operating subsidiary flows to the bank, not the holding company, and, thus, provides a source of earnings that can serve as an important counter-cyclical, diversified source of funds for the bank. If banks cannot diversify their operations through a subsidiary, assets and activities will be siphoned from the bank to the affiliate, leaving the bank with a narrow base of activities and depleted assets. A "narrow bank" will be significantly less stable and more vulnerable to economic shocks than a fully diversified financial institution.
- Second, if a bank needs to raise capital, it can sell the subsidiary. If the activities are in an affiliate, the funds from the sale of the affiliate will not flow to the bank.
- Third, in the event of a bank failure, the FDIC would be able to sell the subsidiary. The proceeds from the sale would be available to the FDIC to reduce the costs of the bank failure that are borne by the taxpayer-backed deposit insurance fund. If the company were a bank holding company affiliate and not a subsidiary, the proceeds from the sale would not be available to protect the deposit insurance fund.
- Fourth, subsidiaries of U.S. banks have for decades engaged overseas in activities, *e.g.,* securities underwriting and merchant banking that are impermissible for the parent bank. U.S. banks' foreign subsidiaries represent our longest experience with securities underwriting and other expanded activities by companies under common ownership with banks. Thus, banks have experience in conducting these activities in a safe and sound manner.
- For these reasons, current FDIC Chairman Tanoue and recent past chairmen Helfer, Seidman, and Isaac have unanimously taken the position that these safety and soundness benefits make the subsidiary structure the preferable option.

Corporate separateness. Subsidiaries are (1) separately organized, (2) functionally regulated, (3) discrete corporate entities, and (4) distinct from the insured bank entity. These factors are common to both bank subsidiaries and holding company subsidiaries. Yet these factors are frequently cited as support for *mandating* the holding company subsidiary structure and *prohibiting* the equivalent use of bank subsidiaries for U.S. financial organizations. This argument fails to consider that a bank subsidiary is an insulated, separate, corporate entity just like a holding company affiliate.

No greater risk to the bank. The risks to the bank from activities conducted in a subsidiary with appropriate safeguards are no greater than if the activities are conducted in an affiliate with the equivalent safeguards. Various legislative proposals considered last year applied appropriate safeguards to bank subsidiaries.

- Under the previous legislative proposals, a bank engaging in new financial activities through an operating subsidiary is required to deduct its investment in the subsidiary from capital and is not permitted to consolidate its assets with those of the subsidiary. Further, the bank must be well capitalized before and after taking the capital deduction. As a result, the bank can lose its entire investment in the subsidiary and remain well capitalized. If the subsidiary loses money, the liability of the bank is limited to its equity investment in the subsidiary and its well-capitalized status is not affected.
- As a further safeguard, transactions between the parent bank and a financial subsidiary are treated the same as transactions between a bank and a bank holding company affiliate for purposes of sections 23A and 23B of the Federal Reserve Act. These provisions require that loans and other covered transactions between the bank and its financial subsidiary are subject to collateral requirements and quantitative limits, and must be made on an arm's length basis. The parent bank's equity investments in the subsidiary would require regulatory approval if the amount that was being invested in the financial subsidiary exceeded the amount that could have been paid in a dividend to a bank holding company, without the approval of the regulator. Moreover, the requirement that the bank remain well capitalized after deducting its equity contribution to the subsidiary provides a significant constraint on downstream flows.
- The holding company structure does not better insulate the bank from the risks of nonbanking activities as some claim. To the contrary, statistics demonstrate that, where corporate veil piercing occurs, it has more frequently occurred between companies that are affiliated by common control *(i.e.,* the bank and a holding company nonbank affiliate) than between a parent and its subsidiary.[1] Veil piercing depends on how the entities conduct their operations and not on how the operations are structured within an organizational chart.

No greater subsidy transfer. It has been suggested that only the affiliate structure effectively maintains competitive equity and prevents banks from transferring to nonbank affiliates any funding advantages that the banks may receive from deposit insurance, the availability of the discount window, and access to the payments system. But, there is no demonstrable evidence to support this claim.

- After factoring in the costs of regulation and what banks pay for the services contained in the federal safety net, it is difficult to argue that any *net* subsidy actually exists. Banks bear significant regulatory costs in return for access to the safety net. Among other things, banks are subject to laws and regulations that require regular examinations, and control exit and entry to the banking system, geographic and product expansion, fiduciary activities, the quality of internal and external information systems, and equal access to credit and other financial services. National banks also are subject to assessments, based on their assets. Taken together, these costs eliminate any net subsidy.
- The way banks behave is further evidence that a net subsidy does not exist. If it existed, one would expect banks to behave in a manner to take advantage of the subsidy. This is not the case. For example, if banks realized a subsidy that lowered the cost of funds, banking organizations would be expected to issue debt exclusively at the bank level. Instead, we see debt issuances by all components of the organization—banks, bank holding companies, and nonbank affiliates.
- Moreover, if banks had a competitive advantage, they would dominate the nonbank financial services markets. However, in many fields, nonbank providers have a bigger market share than banks. As of June 1997, two of the top five largest servicers of residential mortgages were nonbanks, and two of the top five originators of mortgages were nonbanks.[2]
- For the sake of argument (and despite the evidence to the contrary), even assuming that a net subsidy exists, there is no evidence that a bank holding

[1] Thompson, Robert, "Piercing the Corporate Veil: An Empirical Study," *Cornell Law Review* 76 (July 1991), 1036–74.

[2] "Ranking the Banks, Statistical Review 1997," *American Banker*.

company affiliate structure would be any more effective in containing the subsidy than the operating subsidiary structure, under equivalent safeguards. It bears repeating that these safeguards include (1) restricting the bank's equity investment in the subsidiary to the amount a bank could dividend to its parent bank holding company (unless the regulator permits a greater investment), (2) further limiting the size of the subsidiary by deducting the bank's investment in the subsidiary from the bank's capital and requiring the bank to remain "well capitalized" after the deduction, and (3) imposing the same limitations on transactions between the parent bank and the subsidiary that apply to transactions between the bank and its holding company affiliates.

- Similar safeguards and restrictions were used by the Federal Reserve Board to justify its decision to allow foreign banks to have U.S. subsidiaries that engage in all aspects of securities underwriting in this country. In fact, the Board has approved some 18 foreign bank subsidiaries to engage in a full line of securities underwriting and dealing activities in the United States, despite the fact that the parent bank has, according to the Board, the benefits of the bank's home country's safety net and a subsidized cost of funds. These decisions have allowed foreign banks to compete in the United States through the structure those banks find most effective, while denying similar opportunities to U.S. institutions. If the regulatory constraints are sufficient to wall off the flow of subsidized funds to foreign bank subsidiaries, why are they not sufficient to perform the same function for U.S. institutions?

CRA benefits. Foreclosing the subsidiary option diminishes the benefits of the Community Reinvestment Act (CRA).

- The operating subsidiary structure enhances the bank's capacity to perform CRA activities. OCC examiners look at the assets and profitability of operating subsidiaries, among other performance context considerations, to ascertain a bank's capacity for performance.

Consumer and community bank benefits. Forcing most new financial activities to be conducted in holding company affiliates limits the competitiveness of community banks and deprives consumers of the benefits of competition in financial services and access to a full range of financial products.

- Denying banks the opportunity to organize their operations in the manner that is the most effective and efficient particularly affects community banks. The subsidiary option may be the best option for community banks to offer their customers a full range of financial products in the most cost-efficient manner.

- Allowing banks of all sizes to offer financial services using the most effective and efficient structure for that organization ensures that consumers will be able to have the benefits of competitively priced financial products and services, as well as access to the full range of these products and services.

3. Bank Insurance Activities

H.R. 10 contains provisions that (1) permit states to impose discriminatory requirements on banks that limit their ability to compete in the sales of insurance products, (2) permanently freeze the ability of banks to produce new products if the product, or even a component of the product, is labeled "insurance," and (3) limit the traditional deference that the OCC would receive in conflicts with a state insurance regulator over interpretations of national banking law. As a result, banks cannot realize the safety and soundness benefits from true financial modernization by diversifying into new lines of business, and consumers will not realize the benefits of increased competitive pricing of insurance products and product innovation.

A. Insurance Sales Activities/Preemption

Under section 121, well-capitalized national banks may have a wholly owned insurance agency subsidiary that may operate from any location in a state. But H.R. 10 does not repeal the "place of 5,000" restriction that limits banks' direct insurance sales under current law.

Section 104 establishes a complex scheme for determining the scope of permissible state regulation of insurance sales activities by banks and their subsidiaries and affiliates. The provision overturns the U.S. Supreme Court's decision in *Barnett Bank* v. *Nelson*[3] and permits state regulators to impose rules that discriminate against banks and impose significant, anticompetitive, and in many cases virtually incomprehensible sets of restrictions on banks' ability to sell insurance. Under these new preemption standards, banks will have less protection from state discriminatory insurance sales restrictions than they do today.

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[3] *Barnett Bank* v. *Nelson*, 116 S. Ct. 1103 (1996).

Section 104 creates 13 safe harbors under which states may freely regulate bank sales of insurance without *any* limitations. The current version of H.R. 10 *expands* the safe harbors and the potential for increased litigation for banks.[4] It also includes any state law that is substantially the same as, but no more burdensome or restrictive than, any of the 13 safe harbors that are expressly listed within the safe harbor protections.

Section 104 sets out a general rule that no state may—"in accordance with" the preemption standards set forth in *Barnett*—"prevent or significantly interfere" with the ability of a bank to engage in insurance sales or cross-marketing activities. In addition, for state laws that do not fall within the safe harbors, section 104 differentiates between state laws enacted before or after September 3, 1998. For state laws enacted prior to September 3, 1998, the prohibition on a court giving traditional deference to the OCC's interpretation (described below) will not apply and the so-called nondiscrimination standards will not apply.

Specific Concerns

- *Barnett is overturned.* While H.R. 10 says that it codifies *Barnett*, its operative terms do not. The *Barnett* Court uses the words "prevent or significantly interfere" and cites with approval various cases holding that state law is preempted if, for example, it encumbers, impairs the efficiency of, or hampers national bank functions. Thus, H.R. 10 would narrow the judicially developed, well-recognized, and time-tested standards, making it easier for states to pass laws that impinge on national bank insurance sales authority.
- *"Safe harbors" allow states to discriminate against banks.* The "safe harbors" give states the right to impose 13 types of restrictions on bank insurance sales, all of which permit discriminatory treatment of insured depository institutions. States also may add other restrictions that are substantially the same as the safe harbors.

B. Insurance Underwriting

Section 304 prohibits banks and their subsidiaries from underwriting new "insurance" products, unless the OCC had approved the product (except for annuities which are prohibited and title insurance which is restricted) as of January 1, 1997, or a national bank was actually offering the product as of that date. Insurance is broadly defined as (1) any product regulated as insurance as of January 1, 1997, (2) any product first offered after January 1, 1997, which a state insurance regulator determines shall be regulated as insurance and is not on a list in the bill of banking products, or (3) an annuity. Section 305 contains restrictions on title insurance underwriting by banks and their subsidiaries.

Specific Concerns

- *Anti-competitive requirements.* Section 304 may prohibit banks from offering new banking products that are authorized by the national bank charter. Any new banking product will be called into question if the regulator in the state where the product is provided labels it "insurance." Product innovation will be stifled. It is important to note that the consequence of a product being labeled "insurance" under this scheme is *not* that the product will be *regulated* as insurance, but that banks will be *barred* from providing it.
- *Undermines the national bank charter.* National banks will be exposed to the determinations of 50 different state insurance regulators. This means that a national bank may not be able to offer a product in one state that it is free to offer in another.

C. Deference

In a conflict with a state regulator over whether a product is insurance or banking (the answer to which determines whether a bank may produce a product after January 1, 1997 and not merely whether the product will be regulated as "insurance") or whether a state statute is properly treated as preempted, section 306(e) provides that the OCC will *not* receive the traditional deference accorded to federal agencies when interpreting the statutes they administer.

Specific Concerns

- *Traditional judicial doctrine overturned.* All federal government agencies—including some of the

[4] Two other provisions included in this version of H.R. 10 in section 104 add to the issues that may prove troublesome to national banks. First, state antitrust laws and corporate laws of "general applicability" are exempt from the general rule that states cannot "prevent or restrict" a bank or its subsidiaries or affiliates from affiliating with any person as authorized by H.R. 10. The state laws that are protected from preemption under this provision may, however, have a disparate impact on banks and interfere with their ability to exercise federally authorized powers. National banks have previously experienced problems with these types of laws. Second, an exception is made to another general rule that state laws cannot "prevent or restrict" the activities (other than insurance sales and cross-marketing activities, which are subject to a different preemption standard) authorized by H.R. 10. This broad exception covers "state regulation of financial activities other than insurance." This provision is confusing and we cannot determine how it will work, why it is necessary, or what state laws will be covered.

more obscure agencies—are accorded deference on interpreting statutes they are charged with administering.[5] Although the 1984 U.S. Supreme Court decision in the *Chevron* case[6] represents the newest restatement of judicial deference doctrine, the Supreme Court has been giving weight to the construction of federal statutes by executive branch officials since as early as 1809.[7] However, in an unprecedented step, section 306(e) prohibits a court from giving the OCC deference even when the OCC is interpreting the National Bank Act, or even when the OCC is opining on whether a state law or rule interferes with the ability of a national bank to sell insurance. This result singles out national bank insurance activities and uniquely excludes OCC decisions in these areas from the long-standing doctrine of judicial deference.

- *Anti-competitive consequences.* The result of this provision is to limit competition in insurance markets. This provision will have a chilling effect on bank business decisions to offer new products. The bank will no longer be able to rely on the OCC's decisions that have not been tested in the courts if a product may be deemed "insurance" by a state regulator.

D. Other Issues

Section 301 restates that the McCarran–Ferguson Act is the law of the land. Sections 301 and 302 require all persons providing insurance in a state to be licensed in accordance with state law and all insurance sales activities to be functionally regulated by the state subject to the preemption standards in section 104 (discussed above).

Specific Concerns

- *Confusing and conflicting standards.* It is not clear what these provisions mean, why they are necessary, or how they will be interpreted and applied by a court. Retaining these ambiguous provisions in the legislation will only serve to expose banks to additional litigation risk.

4. Bank Securities Activities

Section 181 authorizes well-capitalized national banks and their subsidiaries to underwrite and deal in municipal revenue bonds. In other respects, H.R. 10 limits the ability of banks to engage in many currently permissible activities. Sections 201 and 202 repeal the broker-dealer exemptions for banks under federal securities law, replacing them with a list of certain activities (interpreted and administered by the Securities and Exchange Commission (SEC)) in which a bank may engage without being required to register as a broker-dealer. These provisions have a "push-out" effect forcing banks to use separate legal entities to engage in many securities activities that banks provide today in a safe and sound manner. Under section 206, the SEC has the authority to impose registration requirements on banks that effect transactions in or buy and sell new banking products that are determined by the SEC to be "securities" after consultation with the Federal Reserve Board—but with no other banking agencies. In addition, section 121 contains amendments to current law to prevent subsidiaries of banks and thrifts from engaging in new securities underwriting activities after September 15, 1997.

Specific Concerns

- *Current safe and sound activities will be forced out of the bank.* The various financial modernization legislation proposals under consideration contain provisions that will force banks to use separate legal entities in order to engage in many securities activities that banks currently provide. This is true because, as a practical matter, banks cannot register as broker-dealers due to the SEC net capital rules designed for securities firms rather than banks.

  The proposals require banks to "push out" securities activities into separate securities companies, unless the banks only engage in currently permissible brokerage through a qualified networking arrangement with SEC registered brokers or dealers under conditions enforced by the SEC. Banks that sell, as agent, mutual funds or other securities (other than U.S. and municipal securities) must move the activity to separate SEC-regulated legal entities, either bank subsidiaries or holding company affiliates. In addition, section 201 inserts back into the bill similar provisions that were struck by the Senate Banking Committee preventing a bank from engaging in private placements of securities if it is

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[5] We have found federal cases, for example, that accorded deference to the Korean War Veterans Memorial Advisory Board, the Legal Services Corporation (which is a federally chartered corporation not subject to the full measure of the Administrative Procedures Act), the Pacific Northwest Electric Power & Conservation Planning Council, the Railroad Retirement Board, and the American Battle Monuments Commission.

[6] *Chevron* v. *Natural Resources Defense Council,* 467 U.S. 837 (1984).

[7] *See United States* v. *Vowell*, 9 U.S. (5 Cranch) 368, 371–72 (1809).

affiliated with a securities firm. Other current activities will be subject to limitations. The activities affected include: loan sales or participations if the loans were not "made by a bank," variable annuity sales, securitization of assets if "predominantly originated by the bank or its affiliate," and 401(k) and other securities purchase plans if the bank is not the transfer agent for the securities offered by the plan.

- *Community banks will be particularly disadvantaged.* The *expanded* securities powers under H.R. 10 (except underwriting municipal revenue bonds) are available only to holding company affiliates. Requiring this structure will impose operating burdens and relatively larger costs on smaller banks that do not have a holding company structure in place. Effectively, many community banks will not be able to take advantage of the new authority or will be uncompetitive due to the relatively higher cost of the holding company affiliate structure.

5. Bank Supervision

H.R. 10 contains several provisions that give the Federal Reserve Board confusing, overlapping authority over depository institutions that are regulated by other federal banking agencies. For example, as a requirement to engage in the new financial activities, section 103 requires all subsidiary depository institutions of a financial holding company to be well capitalized. If the *Federal Reserve Board* determines that a financial holding company has a subsidiary depository institution that is not well capitalized, or well managed, the company must execute an agreement with the *Board* to correct the deficiency. Until the conditions are corrected, the *Board* may impose limitations on the activities of the company or any affiliate, including a depository institution. Section 114 gives the *Board* additional authority to impose restrictions and requirements on relationships or transactions between a depository institution subsidiary of a bank holding company and any affiliate of the depository institution (other than a subsidiary of the institution). The *Board* may impose these restrictions if it determines, among other things, that the restrictions are necessary to avoid significant safety and soundness risk to the depository institution or the federal deposit insurance fund.

Specific Concerns

These provisions will subject depository institution subsidiaries of bank holding companies to unprecedented, new regulatory burdens and overlapping, potentially conflicting, regulatory requirements.

6. Consumer Protections

Section 307 requires the federal banking agencies to prescribe joint consumer protection regulations that would apply to retail sales and advertising of any insurance product by an insured depository institution, wholesale financial institution (WFI), subsidiaries thereof (as deemed necessary), and employees/agents thereof.

The regulations must include, for example, (i) a prohibition on misrepresentation (*e.g.*, "any practice" that "could mislead any person or otherwise cause a reasonable person" to conclude erroneously that the product is insured); (ii) a prohibition on coercion (*e.g.*, "any practice that would lead a consumer to believe" that credit is conditional upon the purchase of a particular insurance product); (iii) disclosure requirements to inform the consumer that the product is not insured and is subject to anti-coercion rules; (iv) requirements that insurance transaction activities be physically separated ("to the extent practicable") from areas where retail deposits are routinely accepted; (v) restrictions on referral compensation; (vi) requirements that insurance sales agents/employees be appropriately qualified and licensed; (vii) procedures to receive complaints by consumers alleging violations of these provisions; and (viii) a prohibition on discrimination (except as expressly permitted under state law) against victims of domestic violence. We generally support these types of consumer protection requirements, many of which are substantially similar to protections found in the OCC's October 8, 1996 guidance [OCC Advisory Letter AL 96–8, "Guidance to national banks on insurance and annuity sales activities"].

Specific Concerns

This section also establishes a new preemption scheme prohibiting an "inconsistent" or "contrary" state provision from being preempted by the federal regulations *unless* the federal banking agencies jointly make certain determinations. This provision is extraordinarily convoluted and presents the astonishing prospect that in each state, banks selling insurance would be subject to a different combination of provisions of the federal rules, state provisions that co-exist with the federal rules, state provisions that supersede the federal rules, and state provisions that are superseded by the federal rules. The mix of these provisions could be different in each state in which a bank sells insurance.

7. Community Reinvestment Act

Under this version of H.R. 10, for a bank holding company to engage in new financial activities, all of its subsidiary depository institutions must have a satisfactory CRA rating at the time the holding company applies to become a “financial holding company.” A similar requirement is made applicable to national banks seeking to engage in financial activities through a subsidiary. Section 136 of the bill applies CRA to national and state bank WFIs.

Specific Concerns

The Community Reinvestment Act has achieved positive results, and has led to significant financing for affordable housing, economic revitalization for communities, and increased profitable lending opportunities for banks. As a result, the OCC supports the approach taken in the House-passed version of H.R. 10, which would apply a satisfactory CRA requirement on an on-going basis.

8. Privacy of Bank Customers

The consumer financial privacy provisions in H.R. 10 are included in the following sections:

(1) section 114 permits the Board to impose restrictions or requirements on relationships or transactions between a depository institution and any affiliate (except a subsidiary of the depository institution) if it enhances the privacy of customers of depository institutions, is found to be in the public interest, and is consistent with various federal laws;

(2) section 104 (addressing federal preemption standards) permits states to adopt laws to prohibit the release of certain customer insurance information for the purpose of soliciting or selling insurance (or health information for any purpose) without the customer’s express consent; and

(3) section 109 provides that the ongoing, multi-stage Federal Trade Commission study on consumer privacy issues will be submitted to Congress at the conclusion of each stage, together with recommendations for legislative action.

Specific Concerns

Technological advances and the emergence of diversified financial services companies—which would intensify upon the enactment of H.R. 10—creates a parallel responsibility for policymakers to ensure that customers’ private financial information is properly handled and appropriately safeguarded.

- *FCRA should be amended to restore the federal bank regulators’ examination authority.* Recent amendments to the Fair Credit Reporting Act (FCRA) allow persons related by “common ownership or affiliated by corporate control” to share and use any customer information they possess (in addition to experience information, which can be freely shared) subject to certain requirements. This information may be shared within the corporate family only if clear and conspicuous disclosures are made to consumers that the information may be shared under FCRA and consumers are given the opportunity to “opt-out” of any information sharing.

  The same recent amendments to FCRA also restrict the federal banking agencies’ authority to examine for compliance with FCRA, including the information sharing and opt-out provisions. A federal banking agency may only examine an institution for FCRA compliance if the agency has information—following an investigation of a complaint or otherwise—that an institution has violated FCRA. Absent these circumstances, a banking agency cannot examine for compliance with the FCRA information sharing requirements. It is recommended that full examination authority for the federal banking agencies be restored.

9. National Wholesale Financial Institutions

Section 136 creates both national and state bank wholesale financial institutions (WFIs). These uninsured institutions can be affiliated with insured depository institutions. The bill prohibits WFIs from accepting initial deposits of $100,000 or less (except for a 5 percent *de minimis* amount). While the OCC is given chartering authority over national WFIs, national WFIs in all other respects are supervised and regulated by the Federal Reserve Board.

Specific Concerns

National WFIs will be subject to duplicative, confusing regulation—chartered by the OCC but, for all other purposes, including prompt corrective action, supervised by the Federal Reserve Board and subject to the Board’s enforcement authority. This is tremendously inefficient and confusing.

Statement of John D. Hawke Jr., Comptroller of the Currency, before the General Farm Subcommittee, U.S. House Committee on Agriculture, on the impact of current and projected agricultural credit conditions on national banks, Washington, D.C., February 12, 1999

Statement required by 12 U.S.C. 250: The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Introduction

Mr. Chairman and members of the subcommittee, I appreciate this opportunity to submit a written statement that describes how the Office of the Comptroller of the Currency (OCC) views the impact of current and projected agricultural credit conditions on national banks. I am responding to the subcommittee's expressed desire to learn more about the OCC's recently released booklet from the *Comptroller's Handbook* on agricultural lending and how our examiners use that guidance in their supervisory and regulatory activities in the field.

Today, the U.S. agricultural sector faces its most significant challenges since the mid-1980s. A combination of lower commodity prices and severe weather has created economic difficulties for many farmers in certain regions of the country. The United States Department of Agriculture (USDA) has recently forecasted financial stresses for this sector of the economy at least into the year 2001.[1]

Farmers rely primarily on banks for agricultural credit and, as of September 30, 1998, national banks held $31.9 billion in agricultural credits—18.8 percent of the approximately $170 billion of farm debt last year. While the national bank system is financially safe and sound and well positioned to weather the financial stress of the agriculture sector in the coming years, certain banks that specialize in agriculture lending may need to carefully monitor and reassess the risks of their loan portfolios.

My primary message to the subcommittee is that the OCC believes that a balanced examination approach is the best approach to handling stresses in the agricultural economy. Banks should continue to serve their communities and devise ways to help farmers through temporary financial difficulties. However, bankers must also adhere to sound lending practices. Banks' balance sheets must reflect accurately the risks embedded in their loans. Their reserves for loan losses and capital levels must also be sufficient. If banks are to be a reliable source of agricultural loans in both good and bad times, they must remain financially strong. One enduring lesson from the thrift crisis of the late 1980s is that forbearance on the part of the regulators—particularly at times when the asset values are likely to be less than book value—only leads to more serious problems for banks and the communities they serve down the road.

Given the current agricultural credit conditions, we felt it appropriate to issue a booklet on agricultural lending. The purpose of the booklet is to help examiners and bankers understand the fundamentals of sound agricultural lending, to consolidate existing OCC guidance, and to see that examiners do not automatically criticize loans solely because farmers may need more time to service them. It reflects our enhanced understanding of agricultural credit issues over the past 15 years. I am submitting a copy of that booklet for the record with my testimony. [Attachment omitted. The "Agricultural Lending" booklet, 52 pp., (December 1998) from *Comptroller's Handbook,* is available on the World Wide Web at http://www.occ.treas.gov/handbook/aglend.pdf or for sale for $15.00, from Comptroller of the Currency, P.O. Box 70004, Chicago, Illinois 60673–0004.]

National Banks and Agricultural Lending

Before I discuss specifics on national banks and agricultural lending, I would like to provide a brief overview of present and projected economic conditions in the agricultural sector. The USDA forecasts that farm profits in 1999 will decrease 8 percent to $44 billion from $48 billion last year.[2] The Asian financial crisis in 1998 hit Midwest farmers the hardest as it contributed to a drop in the prices for wheat and corn and secondarily contributed to the collapse of hog prices. This year prices on Southern crops, such as cotton and soybeans, are also projected to significantly decline. The Midwest region, not yet recovered from last year's price

[1] USDA Baseline Projections, February 1998.

[2] Economic Research Service, U.S. Department of Agriculture, December 21, 1998.

declines, is projected to experience a decrease in dairy prices.[3] Recent sources of financial stress such as the Asian financial crisis and the recent devaluation of the Brazilian real have contributed to a decline in American farm exports, an increase in the supply of farm commodities and a stronger dollar.[4] The end result is lower commodity prices, which, coupled with severe weather in certain regions in the country, have placed significant financial strain on parts of the agricultural sector of the economy. Farmers who have assumed a significant level of debt will be under substantial pressure, if farm prices remain low. Thus, we anticipate that some farmers will be unable to service their loans if they continue to be negatively affected by economic conditions in the agricultural sector.

Agricultural lending is broadly distributed across the national banking system, and the lack of concentration of agricultural loans reduces the overall risk to the national banking system. Over 70 percent of the agriculture lending of national banks occurs in lenders that do not specialize in agricultural credit. Since these lenders do not specialize in agricultural lending, their overall exposure to agricultural credit problems is limited.

As of September 30, 1998, 27.9 percent ($8.9 billion) of the national banking system's agricultural credit was held by 528 national banks—one-fifth of all national banks—that regulators classify as agriculture lenders.[5] We are concerned about the impact of the current financial stresses on the balance sheets of these agricultural national banks and the ability of these banks to extend additional credit, if the stresses continue. For example, agricultural banks, which rely primarily on deposits for funding, are more susceptible to regional economic downturns and liquidity problems than national banks overall. On September 30, 1998, the average deposits to total liabilities ratio for agricultural national banks was 94.6 percent compared to 73.2 percent for all national banks.

[3] According to the USDA: hog prices decreased 70 percent from 1997 to 1998; export prices on wheat and corn fell 13 and 14 percent, respectively; 1999 soybean export prices are projected to decrease 17 percent from 1998 levels; large overseas harvests of cotton have resulted in a six-month supply, the biggest reserve in 13 years; and due to record high milk prices and relatively high producer returns in 1998, milk production in 1999 is projected to overtake milk demand, resulting in a sharp drop in milk prices.

[4] According to the USDA, exports were $59.8 billion in 1996 and had declined 10 percent by fiscal year 1998 to $53.6 billion. The latest export projections for 1999 are $50.5 billion—a 16 percent decrease from the 1996 figure.

[5] These are defined by the Federal Deposit Insurance Corporation (FDIC) as banks where agricultural production and farm real estate loans combine to amount to 25 percent of total loans and leases.

Nearly three-fourths of agricultural national banks are in the OCC's Midwestern and Southwestern districts,[6] precisely where many farmers are experiencing difficulties. Thus, the potential for credit quality problems with the agricultural loans is regionally concentrated in the national banking system. As of September 30, 1998, 40 national banks had exposures to agricultural lending that exceeds five times their equity capital. Three-quarters of them are in Nebraska, Texas, and Iowa. In addition, 33 national banks hold non-performing agricultural loans in excess of 10 percent of their equity capital. Twenty of these banks are in just two states: Nebraska and Texas.

It is important to keep in mind, however, that the vast majority of the 528 agricultural national banks are small community banks that are typically strong and profitable. In fact, they average $66.4 million in assets, less than one-twentieth the size of the average non-agricultural national bank ($1.5 billion), have an average equity capital to asset ratio of 10.7 percent as of the third quarter of 1998, and experience an average return on assets of 1.1 percent. Thus, despite our focus on the credit quality of agricultural loans, the agency has not to date found weaknesses in bank loan portfolios of the magnitude we saw in the mid-1980s.

OCC's "Agricultural Lending" Booklet

The OCC has significant supervisory experience dealing with agriculture credit quality issues. We have learned over the years that a balanced examination approach that gives banks the flexibility to work with farmers experiencing temporary financial difficulties is the best approach. During 1984, when national banks last faced substantial agricultural problems, we issued guidance to our examiners instructing them not to classify agricultural credits solely because the borrower's cash flow was negative.[7] That policy proved useful and effective. We have recently clarified and reissued this guidance as part of our *Comptroller's Handbook,* in the booklet titled "Agricultural Lending." This booklet serves as a single reference source for our examiners and for bankers and draws upon the lessons we have learned through the examination process about making sound agricultural loans and managing agricultural lending risks.

The booklet addresses three important subjects. First, it provides background information on the characteristics of agricultural loans that distinguish them from other

[6] These districts cover Arkansas, Iowa, Kansas, Louisiana, Minnesota, Missouri, Nebraska, North Dakota, Oklahoma, South Dakota, and Texas.

[7] OCC Examining Circular 222, May 21, 1984.

kinds of commercial loans. It offers specialized information to augment the more general advice and guidance that we give our examiners about loan portfolio management and credit underwriting. Second, it discusses how we evaluate individual agricultural loans. And third, it describes how we evaluate a bank's agricultural loan portfolio and its administration of that portion of its lending business. Let me discuss each of these areas in more detail.

The booklet highlights the special risks inherent in farm lending, including underwriting, credit administration, and risk management issues. For example, production loans are usually repaid though the sale of the underlying collateral. On occasion, prices farmers receive for their crops or livestock do not generate sufficient cash to repay the entire loan, necessitating a refinancing of the unpaid portion into next year's loan (referred to as carryover debt). In the booklet, we discuss ways in which bankers can work with their farm borrowers in these situations and we make clear that this carryover debt should not be automatically classified. Also, the booklet points out that agricultural lenders are exposed to significant risks that are not in the control of an individual borrower, such as shifting commodity prices and severe weather conditions. We note that banks can reduce their exposure to those risks with hedging strategies or by requiring the purchase of crop insurance.

The methods by which the OCC evaluates credits receives heightened attention when the economy softens. The "Agricultural Lending" booklet describes in some detail what we expect our examiners to take into account in making those judgments. The booklet advises them to weigh carefully the full range of relevant factors, including the borrower's financial strength, payment history, future prospects over the life of the loan, and the value and quality of the collateral. The booklet explicitly states that, just because a farmer carries over an unpaid loan from a prior crop year, the examiner should not automatically lower the credit quality rating on the loan through the loan classification process.[8] Further, the booklet makes it clear that the potential for loan classification does not mean that the banker should terminate the credit. Additionally, our examiners understand that a borrower with a problem or classified loan at one point in time may become a solid customer in the future. Efforts by the bank to restructure loans by extending repayment terms or advancing additional credit, when prudently done, can improve the prospects for repayment. Our examiners consider all of these factors when they judge the quality of agricultural credits.

With regard to assessing the nature of the bank's agricultural loan portfolio and the quality of its management of that business, our primary objective is to make certain the bank remains strong and healthy so it can continue to be a source of financial support for the community it serves. A bank must maintain sound underwriting practices and solid internal risk management controls. If it makes exceptions to its lending policies, the bank must know the number and type of exceptions it is making and how these exceptions could affect its expected future earnings or exposure to losses in the event of default by the borrowers. The bank must also conduct a periodic independent loan review to identify and evaluate risks. And they must make provisions for possible losses in light of changing economic conditions. These are all essential risk management practices, and remain fully consistent with a flexible loan workout program when borrowers get into trouble. Banks need to work with an otherwise sound borrower experiencing temporary financial difficulties, but the bank must also accurately reflect in its loan portfolio the impact of such a decision.

OCC Examination Approach

We are actively taking steps to make certain that we apply our supervisory policies in a consistent manner. We conduct national and district reviews of our examination approach to avoid overreaction by our examiners to agricultural credit conditions. Additionally we work with other banking regulators to ensure that we all treat similar loans in a similar manner.

Late last year, in an attempt to assure consistency among our examiners and to provide a platform for training some less experienced examiners, we performed a cross-sectional examination of 10 agriculture banks. This process, which was led by an experienced agricultural credit examiner, focused on national banks active in agriculture lending. Examiners experienced in assessing agriculture loans were paired with less-seasoned examiners and jointly conducted a credit review of each of the 10 banks.

At a more local level, the Southwestern District[9] has established an internal group of examiners experienced in agricultural lending to be an information resource and clearinghouse for agricultural loan classifications. This group reviews proposed classifications and provides feedback to examiners to ensure classification criteria are applied in a manner consistent with OCC guidelines.

[8] Classification of a loan is explained in detail in The *Comptroller's Handbook for National Bank Examiners*, Section 215.1, March 1990.

[9] Includes the states of Arkansas, Louisiana, Oklahoma, and Texas.

On an interagency basis, we are making some initial efforts to standardize the treatment of certain agricultural examination issues, such as valuing agricultural collateral and analyzing farm cash flows. The Southwestern District office has initiated a program with the Dallas office of the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Bank of Dallas, and the Texas State Banking Department to share information on agricultural conditions and lending activities in the Southwest. We are hopeful that programs such as these will ensure a more consistent regulatory treatment of loans to troubled agricultural borrowers.

Finally, all national banks have the opportunity at any time to raise examination concerns. The OCC's ombudsman and his staff are responsible for ensuring that the OCC appeals process provides a fair and speedy review of disagreements on agency findings or decisions. The office has the discretion to supersede any agency decision or action during the resolution of an appealable matter.

OCC Outreach

The OCC has an active outreach program and we have stepped up our activities with bankers and trade groups in our districts that have been most affected by problems in agriculture. Our purpose is to educate bankers about our policies, candidly discuss issues, and identify local problems. This dialogue helps us to strike the right balance in our supervision of agricultural banks, and prevent overreaction to existing economic conditions affecting the agricultural sector. Topics of recent meetings include credit classifications; the impact on agricultural credit conditions of reduced yields on corn and wheat from drought; crops lost to freezes and floods; and low beef and pork prices.

In addition, our district offices are offering training programs for bankers. For instance, last September, the OCC's Omaha Field Office organized an outreach session on agriculture credit classification for over 200 senior lenders and chief executive officers from banks in Nebraska and Iowa. The program was so successful that it has been incorporated into the training programs of three other OCC field offices.

Conclusion

Although the OCC has concerns about the difficulties farmers are facing in some areas of the country, the current problems in the banking system from exposure to agricultural credits are not as severe overall as those we saw in the mid-1980s. Nearly all agricultural banks hold more capital and have higher levels of loan loss reserves than 15 years ago. Therefore, most agriculture banks are currently in a sufficiently strong financial position to work out problem credits with their farm borrowers.

As Comptroller, I am determined that the OCC maintain a balanced supervisory approach: one that avoids overreaction to problems and results in a steady flow of credit to agriculture, but one that also ensures that national banks remain safe and sound and that the system does not suffer overall from sectoral difficulties. We can achieve these objectives through consistent application of proven polices under which we encourage banks to work with their customers and to adhere to sound lending fundamentals.

Remarks by John D. Hawke Jr., Comptroller of the Currency, before the ABA National Conference for Community Bankers, on the shortcomings in proposed financial modernization legislation for community banks, Orlando, Florida, February 22, 1999

I've been Comptroller for about 10 weeks now, and I must say that it's been an enlightening and humbling experience. The OCC is blessed with an impressive staff of professionals, and, as I listen to their presentations on various regulatory issues, I can't help but recall words attributed to the great historian Will Durant when he was well into his eighties. "Sixty years ago," he said, "I knew everything, but now I know nothing."

Durant viewed education as "the progressive discovery of our own ignorance." With that in mind, I've always recognized that it was better to listen first and figure out how much I had to learn before venturing out to speak and letting the world in on it. But, although my education is by no means complete—and never will be—I believe that it's important to speak out now on issues of concern to us all.

As many of you know, I don't come to the job of Comptroller as a novice to the banking business. I've spent more years than I care to count as a banking lawyer, law school professor, bank regulator, and, most recently, as a senior member of Secretary Rubin's team at the Treasury Department, with special responsibility for domestic issues. Over these many years, a number of banking subjects have been particularly near and dear to me—and none more so than what brings you here to Orlando: your role—your critical role—as the community bankers of America.

The basic role that you play hasn't changed appreciably since I was a boy. I clearly remember walking into a bank in my home town on Long Island to open my first Christmas Club account with my earnings from shoveling snow. They seemed genuinely happy to have me as a customer.

That experience was the start of my education in banking. It continued through three decades of law practice that involved both large and small banks. And the lesson I learned over time was that banks are not just about loans and deposits. They're crucial to the social fabric of a community as well as its economy. They help transmit shared values: the values of thrift and industry, permanence and stability, and service to the community. They teach us through example that doing the best we can for ourselves and our families requires the financial and moral support of the community behind us.

Many things have changed in my old home town. When I was growing up, three or four banks, all locally owned, served a population of around 25,000. The executives who ran the banks were the leaders of our community.

After leaving the bank for the day, they assumed many other important roles—as library board members or church trustees, Scoutmasters or community fund raisers. Home office protection and restrictive branching laws preserved the local character of banking. Our corner of the world was safe and secure.

Today, this town is still home to 25,000 people. Now, 10 banks do business there. But none of these banks is locally owned. One is a subsidiary of a holding company located in Rhode Island, three states away. Five others are branches of banks headquartered in New York City—only 25 miles distant, but a world apart in many respects.

I'm sure that these banks compete vigorously with one another, offering their customers all sorts of new products and services. I'm sure that the bank's managers and employees give generously of themselves to the community after hours. But I wonder whether my Christmas Club account would be welcomed as warmly today as it was 50 years ago.

Analysts used to scoff at the large number of independent banks in the United States compared to other industrialized countries. The difference ran literally into the tens of thousands during the heyday of unit banking back in the 1920s. It wasn't unheard of for towns of 200 or 300 people to be home to two or more locally owned banks.

Certainly, from a purely economic standpoint, that structure left a lot to be desired in terms of efficiency and often stability. Many of these small, thinly capitalized institutions proved unable to withstand even minor economic shocks. That's when some people really came to appreciate their banks and the importance of their contributions—when they were gone. Some of these towns never did recover.

We've come a long way since then. The U.S. banking system has become more rational and coherent—or so some would say. From more than 22,000 commercial banks in 1922, we're down to perhaps 9,000 today, despite our vast gains in population, geographic dispersion, and economic output over that period.

Not many people predicted how rapidly this consolidation would occur, especially in recent years. I certainly didn't. Still, despite this rapid consolidation, the United States still boasts many more banks than the second-place country, Germany. This is not the result of the size of our economy or population. Rather, it's the outgrowth of our communities' enduring dependence on the tangible—and intangible—products and services that independent banks have traditionally excelled at providing.

And, by all accounts, you're doing a better job of providing those services than ever before. If community banks were once a source of vulnerability in our financial structure, that couldn't be less true today. You've turned your natural advantages into assets.

You—who know your customers by their first names—are well positioned to satisfy their financial needs and wants. You—who have your ear to the ground—are in a position to respond to changing local business conditions before the news has flashed on your competitors' computer screens perhaps hundreds of miles away. No cumbersome, impersonal banking bureaucracy can compare with what you can do when it comes to delivering the products and services your customers want, when they want it.

That's why community banks have been particularly successful in the small business loan market—more successful, apparently, than big banks or, indeed, any other class of financial provider. You bring the attributes small business people seek in a financial provider: local ownership, quick decision-making, accessible senior management, outstanding service, and intimate understanding of their business and their markets. And you continue to build on these attributes to create important new growth markets in agricultural, commercial, and residential real estate lending.

The numbers reflect your success. Last year, community banks earned a higher return on assets than either megabanks or the commercial banking industry as a whole. The average capital ratio for community banks was over 11 percent, compared to 8½ percent for the industry at large.

Non-interest income—a safeguard against over-dependence on loans—has increased significantly, as new fee-generating products and services are introduced. And community banks are making tremendous strides in improving their efficiency ratios, so that you can keep more of the income you earn and continue to compete effectively against larger financial institutions. These performance measures speak volumes about your skill and acumen.

Still, you face major hurdles today and into the foreseeable future. Some of these are common to the industry, others unique to community banks. For example, while I know the value that you add to your customers and communities, and you know it, some of them may not know.

But they should. It's vitally important that you get the recognition you deserve for all that you do. Customer service—which really means being sensitive to the way your institution is perceived by your customers—is an area where community banks have a natural and strong advantage over their multimarket competitors.

Some of the challenges you face are the offspring of your own success. You can't take too much for granted: your best customers can very easily become someone else's. That's especially true in the small business market, where nonbanks are aggressive competitors.

Accordingly, some analysts are predicting lagging earnings growth for community banks, as competition for new loans erodes margins and market share, and more loans find their way into the problem loan category. And it's a creative and dextrous banker indeed who can achieve continued savings in overhead without also undermining the service quality so important to your customers.

I know that liquidity and a dwindling deposit base are concerns that keep you up at night. They should. To sustain current loan volume, new funding sources must be identified as traditional sources increasingly dry up. That's why the Administration has supported broader access for community banks to the resources of the Federal Home Loan Bank System, as part of a broader reform of the system.

Technology poses challenges all its own: what's the right mix of automation and personal service? How best to cope with competition over the Internet? And, most urgent of all, will you and your information systems be ready for the century date change—Y2K [year 2000]?

As if the marketplace weren't making your lives interesting enough, Washington keeps throwing new complications at you. One bright idea that recently came out of D.C. is the proposed federal requirement that you adopt policies and programs to "Know Your Customer." The banking agencies are still in the process of receiving comments on this proposal. But I ask you: Do the community bankers of America really need new federal regulations telling you to know who your customers are—something you already do better than anyone else in the business?

I also suspect that doubt has crossed your minds as to whether the financial modernization debate in Congress last year and the debate already under way again this year is really worth getting exercised about. I know how strong the temptation must be to write off the whole show as just another piece of political theater, of little serious consequence to your institution's day-to-day health and the financial welfare of your customers.

It would be easy to ignore this debate. But it would also be a major mistake. Once in a blue moon, Congress has an opportunity to fundamentally reshape key sections of our national landscape. This is one of those rare occasions. Today's financial marketplace is governed by laws written more than 60 years ago. It might be another 60 before the occasion for fundamental reform arises again. I think you'll agree that, for that reason alone, it behooves everyone with a stake in the outcome to follow the debate carefully. And no one has a bigger stake in the outcome than the community bankers of America.

It's no exaggeration to say that the legislation now under consideration in Congress could profoundly affect your future, one way or the other. Much has been said about specific provisions of that legislation, and, in a moment, I'll add a few words of my own. But it's imperative that we not lose sight of what the broader impact of the proposed legislation could be if it were enacted.

In my view, it could really mark a turning point in the way financial services are provided in this country. It holds the potential that banks will be diminished as financial services providers and replaced with holding companies made up of separate, specialized product providers. It could signal the end of the era of the full-service, integrated financial provider.

In particular, if the legislation mandates a rigid, "one size fits all" format in order to take advantage of new opportunities, banks would be denied the flexibility they need—today more than ever—to compete successfully in the financial marketplace. Such constraints would inevitably weaken our banks, as bank resources were upstreamed to fund holding company ventures and bank earnings opportunities were diverted to holding company affiliates.

I must say, I find it inexplicable that any agency charged with safeguarding the safety and soundness of banks, would insist on a rigid, holding-company-only format, that would deprive banks of the opportunity to diversify their earnings and would force resources *out* of banks to fund new activities in holding companies.

In short, depending on how it's structured, financial modernization could usher in a new era of prosperity—or one of prolonged marginalization—for community banks. All this—and more—is riding on the outcome of this debate.

Unfortunately, in my view, this year's version of H.R. 10 contains many of the defects that were present in last year's legislation. If the current version is enacted into law in anything like its present form, I'm convinced that the results will not be helpful to community banks.

Let me give you an example of what I mean. One reason banks are relatively healthy these days is that they have eagerly embraced new techniques for controlling risk and diversifying income. In general, loan portfolios are better balanced among types of loan products and some whole categories of loans have been pushed off the books entirely through securitization.

Just as important, as I mentioned earlier, non-interest income has been rising steadily as a percentage of total revenues over the past 15 years, with especially dramatic gains registered over the past five. Banks today derive significant revenues from selling various types of financial products and from such activities as investment advice, asset management, and data processing. This fact reflects the clear recognition on the part of bank managers of the importance of diversifying earnings flows.

One of the products that all customers need and want is insurance. The opportunity to sell insurance is frequently a natural outgrowth of a bank's day-to-day banking activity. And you should be able to offer those products without unreasonable burdens. The sale of insurance as an agent has little or no financial risk attached to it and does not require significant capital. Few analysts doubt that insurance sales can make an important contribution to a bank's revenue stream and thereby advance the industry's general safety and soundness.

Community banks particularly stand to benefit. So do your customers. Studies show that most Americans are seriously underinsured. Lowering the cost of insurance through increased competition in the sale of insurance products is one of the best ways I can think of to help American families obtain the coverage they need. Moreover, using modern and efficient delivery techniques, banks can improve access to insurance products for segments of the market that have long been underserved or even ignored in the past by the traditional, labor-intensive system of independent agent delivery.

Of course, none of these advantages will come to pass unless banks are permitted to compete freely and fairly with other insurance providers. But H.R. 10 raises so many obstacles, and presents so many opportunities for controversy and litigation, that it's hard to see how these provisions square with any reasonable concept of financial modernization.

Let me give you just a few examples.

H.R. 10 would permanently restrict the ability of banks and bank subsidiaries to offer insurance in a principal capacity to those products already approved by the OCC prior to January 1, 1997. This means not only that banks could never become innovators of insurance products, but it also means that their ability to offer innovative banking products that may have some insurance elements in them could be severely curtailed. Indeed, under this provision, banks could not even take advantage of innovations introduced by others.

Some of you work with banks in communities of fewer than 5,000 people. If you do, and yours is a national bank, H.R. 10 would not take away the right you have under present law to sell insurance products directly to your customers. But if you're in a community larger than 5,000, then all bets are off: H.R. 10 would require you to form a holding company or subsidiary to conduct insurance activities.

Is that really financial modernization? I don't think so.

Finally, there is this item. While H.R. 10 upholds the right of banks to sell insurance without interference from the states in principle, it then proceeds to undermine that principle by setting out 13 areas in which states may discriminate with impunity against bank insurance sales. They include advertising, licensing, disclosure, and much more. Any state that was intent on burdening insurance sales by banks in order to preserve competitive advantages for nonbank sellers of insurance would be given virtually free rein to do so if H.R. 10 were to become law. That would be bad for competition, bad for communities, and bad for consumers.

While the handful of very large banks who negotiated this language may have the resources to defend their positions in lengthy and costly litigation, community banks clearly don't. No bill with such potential to impede the fulfillment of your historic responsibilities can be good for America.

How well you would fare under its provisions should be an important test of any financial modernization legislation. In its present incarnation, H.R. 10 does not pass the test. It's time to put our heads together and our parochial interests aside to come up with one that does.

By taking these steps now, we can ensure that community banks continue to play their critical role in our nation's economic and social life. Genuine financial modernization legislation will safeguard a more secure future for you and your customers. I look forward to working with all concerned parties to that end.

Statement of John D. Hawke Jr., Comptroller of the Currency, before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, on the Financial Services Act of 1999 (S. 753), Washington, D.C., February 24, 1999

Statement required by 12 USC 250: The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Introduction

Mr. Chairman and members of the committee, thank you for the opportunity to appear before you today to comment on the discussion draft titled the "Financial Services Act of 1999" [S. 753]. Virtually everyone agrees that the laws that prohibit affiliations among banks and other financial services providers and limit the ability of banking organizations to diversify their financial activities are archaic. Changing these laws in ways that promote increased competition, greater efficiency, and more effective delivery of financial products to consumers will strengthen U.S. financial services firms and benefit their customers.

Financial modernization is both a political process and a process of innovation in a competitive marketplace. Every day, financial services firms evolve and adapt to serve the changing needs of their customers. Technological advances and the development of new financial products and services have blurred the lines that once separated the offerings of banks, securities firms, and insurance companies. As a result, consumers of financial services now have a greater choice of financial services and products, at more competitive prices.

An important goal of financial modernization legislation should be to ensure that the government does not impede the process taking place in the marketplace. Of course, some constraints are necessary to ensure that important governmental interests are safeguarded, and that the interests of consumers are properly protected. But legislation that is crafted to discriminate against any segment of the industry, or to limit the choices financial firms have for organizing their businesses for no compelling or clearly demonstrable public policy purpose needlessly retards the real and dynamic financial modernization occurring in the marketplace. Even more significantly, legislation that will diminish the safety and soundness of our insured financial institutions should not be enacted, particularly under the guise of "financial modernization." I am concerned that key provisions of this discussion draft may have that effect.

In my testimony today, I will discuss why I believe that financial modernization legislation should be pursued in a form that will not interfere with the free operation of financial markets, except to the degree necessary to protect fundamental and clearly demonstrable government interests such as promoting the safety and soundness of our financial system and safeguarding the interests of consumers. I will then broadly address the provisions of the discussion draft that relate to bank organizational structure and consumer protection issues. I am attaching to my testimony a supplemental analysis of certain key provisions of the discussion draft and the Office of the Comptroller of the Currency's (OCC) views on the issues they present. My testimony will highlight some areas we support and those that concern us.

Modernization Has Been Occurring in Financial Markets

Federal laws restricting bank geographic and product diversification date back nearly 70 years. Many of these restrictions have been removed, allowing banks to become more efficient and competitive, but significant constraints still exist. Geographic restrictions on bank location were dramatically reduced when the Riegle–Neal Interstate Banking and Branching Efficiency Act was passed in 1994. However, other laws restricting the activities of banking organizations remain, most notably, the Glass–Steagall Act of 1933, which was intended to separate commercial banking from investment banking, and provisions of the Bank Holding Company Act that confine the ability of corporations owning banks to diversify into other financial activities.

It has become clear in recent years that these constraints segregating various sectors of the financial marketplace have outlived their usefulness. The financial services marketplace has undergone enormous changes. Banks, securities firms, and insurance companies compete directly through an array of similar products and services. Regulatory and judicial rulings continue to erode many of the barriers separating the different segments of the financial services industry. In short, technological and financial innovation, together with market pressures to offer consumers a wider array of services, are breaking down the traditional segmentation of the financial services marketplace.

Many financial services providers have been able to respond to these competitive forces without legislation. Clearly, the time has come for Congress to dismantle antiquated constraints that exist in current law and bring the statutory framework that governs the financial services industry into line with the realities and needs of the marketplace. Mr. Chairman, this discussion draft goes a long way toward providing a blueprint for financial modernization, and I want to commend you for bringing forth an innovative proposal early in this session of Congress that contains many positive elements. However, I respectfully regret to say that one key provision of the discussion draft will impose a needless constraint on the ability of banks to take advantage of the broadened powers that the draft proposes to make available, and will not, therefore, permit them to compete in the most efficient manner. This provision could have a significant adverse effect on the long-term safety and soundness of our banking system. Also, as discussed later in my testimony, I am concerned that this proposal will, in practice, make the process for evaluating bank compliance with the Community Reinvestment Act more burdensome for banks.

Ability to Diversify Products and Services is Essential to Banks' Safety and Soundness

Preservation of the safety and soundness of the banking system is a fundamental government interest and a pivotal consideration in any financial modernization legislation. For this reason, we have supported the inclusion of strong safety and soundness provisions, in tandem with any authorization for expanded activities. But protecting the safety and soundness of banking institutions involves more than simply writing safeguards against loss into the law. Providing banks—large and small—the opportunity to maintain strong and diversified earnings through a range of prudently conducted financial activities is an equally critical component of safety and soundness.

Historically, banks have been heavily dependent on net interest margins—generated through traditional lending—as a source of earnings. This makes banks particularly vulnerable to changes in economic conditions. During the 1990s, the net interest income of commercial banks has declined, both as a percentage of assets and as a percentage of net operating revenue; the growth in the volume of lending activity due to the strong economy has been offset by significant compression in bank net interest margins. At the same time, however, banks have been able to preserve or enhance their profitability through growth in noninterest income. In the last 10 years alone, noninterest income has increased from approximately 30 percent of net operating revenue to 39 percent. Noninterest income consists primarily of fees, service charges, commissions, and the performance of data processing services for others, and is equally critical to large and small institutions trying to enhance and vary their income streams. Thus, the ability of banks to continue to pursue market opportunities that diversify their sources of income is critical to their long-term health.

Banks can seek additional earnings sources by providing new products and services or moving into new geographic markets; or they can improve earnings by reducing their operating costs or increasing their risk profile in their lines of business. The OCC and other financial institution regulators have increasingly expressed concern about banks taking on additional credit risk to achieve high earnings targets, particularly given the slowdown in global economic activity and the likelihood of stresses in regional economies. Evidence over the past year showing deterioration in the quality of loan underwriting standards for commercial and industrial loans has been a particular source of worry.

Product, geographic, and income diversification all contribute importantly to bank safety and soundness. Many different factors have been responsible for the waves of bank failures that have characterized various periods of our financial history. Yet, one consistent factor has been excessive *concentrations*—geographic concentrations or concentrations in one or another type of *lending*. The high rate of bank failures in the 1920s was largely confined to small agricultural banks that lacked diversification with respect to either geography or lines of business. In the early 1980s, banks that had excessive concentrations of loans in the oil business failed in large numbers. Many of the banks that failed in the years 1984–1986, when agricultural land prices fell more than 40 percent from their 1981 peak, also appear to have suffered from an inability to diversify. And, finally, in the late 1980s and early 1990s, bank failures throughout the world were associated with excessive real estate lending.

Ideally, of course, bank regulators could anticipate what geographic areas and product lines would be associated with future loan losses and would use their powers of persuasion to prevent banks from developing heavy exposures in lending to those areas. Given the impossibility of perfectly foreseeing the future regarding the nature and location of lending problems, however, the prudential strategy of diversification reduces the vulnerability of banks to unexpected losses from lending, wherever they may occur.

A wealth of empirical research demonstrates that diversification is critically important to maintaining a strong banking system. Firms with diversified assets and revenue streams can better withstand economic shocks during the business cycle, whereas firms limited by geographic or product restrictions can be affected more seriously by downturns. Diversification can enable banks to increase their average rate of return for any given volatility of return, or to reduce the volatility of earnings for any average level of return, in either case reducing their probability of failure.[1]

Risk management is central to the business of banking, and banks have demonstrated they can effectively manage a variety of risks. Banks already manage complex risks, such as those associated with derivatives and other off-balance sheet activities—risks that are similar to those presented by new financial activities. The effect of the discussion draft—which allows some additional diversification for small banks, but forces larger banks and smaller banks owned by holding companies to remain primarily intermediaries of credit risk—is to make those larger banks and holding company–owned community banks inherently more exposed to risk than banks that are permitted to diversify their sources of income. When bank financial activities are restricted, risk exposures are correspondingly concentrated, and banks that are less diversified become more vulnerable to economic shocks.

Operating Subsidiaries Will Strengthen Banks and Enhance Safety and Soundness

Financial modernization legislation should not artificially restrict the ability of financial services providers to choose, consistent with safety and soundness, the most efficient way to conduct their business. There is no a priori governmental interest in restricting organizational choice, and with appropriate safeguards, expanded activities may be conducted safely and soundly in either a bank subsidiary or a bank affiliate.

The discussion draft under consideration today mandates that larger banks—those with over $1 billion in assets and any community bank owned by a holding company—wishing to diversify into new activities as principal do so only through bank holding company affiliates. This approach needlessly denies firms the choice of undertaking new financial activities through a bank subsidiary structure. Imposing this restriction on larger institutions, in particular, would disserve safety and soundness principles because these are the institutions whose instability could have the greatest systemic effect and whose failure could be most expensive for the federal deposit insurance fund.

In short, prohibiting banks from electing the option to use operating subsidiaries will undermine, rather than enhance, safety and soundness. It will inevitably force resources out of banks, lessen the opportunities for large banks to diversify their earnings, and diminish the protections for the federal deposit insurance fund. The Federal Deposit Insurance Corporation (FDIC) has repeatedly testified that, in the event that a bank should itself suffer financial difficulties, earnings from bank subsidiaries can compensate for a downturn in bank profits, and, in the event of bank failure, the existence of such subsidiaries can significantly reduce the losses of the federal deposit insurance fund. In 1997, former Chairman Helfer noted in her testimony that “[w]ith appropriate safeguards, having earnings from new activities in bank subsidiaries lowers the probability of failure and thus provides greater protection for the insurance fund than having the earnings from new activities in bank holding company affiliates.”[2]

Consider the business decision facing a banking organization that may want to take advantage of the newly legislated opportunity to expand into insurance or securities activities on a principal basis. If the only organizational choice available is the holding company affiliate, it is highly likely that resources of the bank will be drawn down to capitalize and fund the new activity. The bank will upstream dividends to its parent either to inject capital into the new affiliate, or to support new holding company debt or equity issued for that purpose. The bank itself will reap no direct financial benefit from the new activity. In fact, since many of the business opportunities of the new affiliate may be generated by the day-to-day business of the bank, the bank will be deprived of profit opportunities that would rightfully belong to and be captured by it if the operating subsidiary format had been permitted.

By contrast, if the new activity could be positioned in a subsidiary of the bank, any capital or funding provided by the bank would remain as part of the bank’s consolidated resources. In addition, banks would be able to capture directly the benefits of new business opportunities that may be closely related to, or generated by, their normal day-to-day banking activities. Income flows resulting from such new activities would flow

[1] For a review of the literature, see Mote, Larry R., “The Separation of Banking and Commerce,” *Emerging Challenges for the International Services Industry,* JAI Press, 1992, pp. 211–217, and Whalen, Gary, *Bank Organizational Form and the Risks of Expanded Activities,* Economics Working Paper 97–1, January 1997, pp. 5–12.

[2] See testimony of Ricki Helfer, Chairman, FDIC, on financial modernization before the Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises, Committee on Banking and Financial Services, U.S. House of Representatives, March 5, 1997.

directly to the bank, would not be diverted to the holding company, and would provide the bank with a diversified source of earnings.

The FDIC also recognizes the benefits of diversification for the safety and soundness of the banking industry. FDIC Chairman Donna Tanoue and former FDIC chairs have consistently pointed out that the subsidiary format strengthens the bank. Last September, in a joint article in the *American Banker*, former chairmen Helfer, Isaac, and Seidman stated their position clearly: "Requiring that bank-related activities be conducted in holding company affiliates will place insured banks in the worst possible position. They will be exposed to the risk of the affiliates' failure without reaping the benefits of the affiliates' successes."[3] In her testimony before the House Banking Committee just last week, Chairman Tanoue stated that "the subsidiary structure can provide superior safety and soundness protection."[4]

Moreover, longstanding policy and practice of the Federal Reserve Board demonstrates that banking organizations can safely and successfully engage in expanded financial activities through bank subsidiaries. For example, the Board has long permitted U.S. banking organizations to engage in securities activities overseas through foreign subsidiaries. At year-end 1997, U.S. banking organizations operated 100 direct and indirect bank securities subsidiaries, a high proportion (88 percent) of which were profitable, with aggregate net income of $732.3 million.[5]

This comparison also highlights the discriminatory nature of the structural restraints the discussion draft would impose on U.S. banks as compared to foreign banks. Under the discussion draft, U.S. banks could have subsidiaries—operating abroad—that conduct an expanded range of financial activities. But a *U.S.* bank's domestic subsidiary could not engage in the activities that are permissible for that bank's foreign subsidiary. Also, a *foreign* bank may engage in nonbanking activities in the United States, including securities underwriting, through a direct subsidiary of the bank. But a *U.S.* bank could not have a *U.S.* subsidiary that engages in the same range of activities permitted for a *foreign* bank's *U.S.* subsidiary. Thus, U.S. law would allow a foreign bank to use the structure it determines most efficient for the delivery of products and services in the United States, while U.S. banks would be restricted to a single format in this country. This result cannot be rationalized.

In addition, the discussion draft uniquely discriminates against large national banks relative to *state* banks by retaining or imposing burdensome statutory requirements that are not imposed on state banks. For example, national bank subsidiaries are not authorized to engage as principal in expanded financial activities; state banks are subject to no such comprehensive bar. Further, although the discussion draft requires that all of a national bank's depository institution affiliates be well capitalized and well managed in order for the national bank's subsidiary to conduct new *agency* activities, no similar requirements are imposed on either state banks or thrifts engaged in the same activities through subsidiaries. And national bank subsidiaries are further limited to conducting those expanded agency activities *only* through a *wholly owned* subsidiary. Thus, national banks, but not state banks, are deprived of the ability to use joint ventures or consortiums of banks to engage in new agency activities.

One could argue that, to protect the interests of the deposit insurance fund and ensure prudent bank supervision, the *only* format that should be used for expanded activities is the operating subsidiary. But individual banking organizations may have particular reasons, based on their business, why the use of a holding company affiliate is better for them, and a prescriptive approach would be inconsistent with the basic principle I discussed earlier—that restrictions on organizational format should not be imposed except where unavoidably needed to protect clearly defined, compelling public interests.

That is not the case here. There is no clearly defined, compelling public interest that requires that larger banks (those over $1 billion in assets), and *any* size bank with a holding company, should be barred from engaging in expanded financial activities in a subsidiary of the bank. In fact, common sense and safety and soundness considerations argue strongly for allowing those banks the same opportunity to diversify through bank subsidiaries as is provided for small non-holding company banks.

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[3] "Ex-FDIC Chiefs Unanimously Favor the Op-Sub Structure," *American Banker*, September 2, 1998.

[4] See testimony of Donna Tanoue, Chairman, FDIC, on H.R. 10, the Financial Services Act of 1999, before the Committee on Banking and Financial Services, U.S. House of Representatives, February 12, 1999.

[5] At year-end 1997, these 100 direct and indirect bank securities subsidiaries had aggregate total assets of $249.5 billion. They represented 90.9 percent of the total number of overseas securities subsidiaries and accounted for more than 98 percent of the total assets in all foreign securities subsidiaries. The average aggregate rate of return on assets for bank securities subsidiaries over the 1987–1997 period was around 60 basis points, roughly three times higher than the comparable figure for holding company securities subsidiaries. See Whalen, Gary, *The Securities Activities of the Foreign Subsidiaries of U.S. Banks: Evidence on Risks and Returns*, Economics Working Paper 98–2, February 1998.

Arguments about the existence of a "subsidy" are ephemeral and do not negate these basic safety and soundness considerations. Moreover, even if it were assumed for the sake of argument that some type of subsidy were enjoyed by banks, the existence of a subsidy at any place in the bank holding company organizational structure benefits the consolidated organization, and the organization can allocate the benefit of that subsidy in a variety of ways to whatever element of the organization it chooses. If one seeks to limit the transference of a subsidy by blocking the flow of funds, the prudential constraints on lending and investment that the OCC supports would contain with equal efficiency the spread of a subsidy to a bank subsidiary or a holding company affiliate,[6] and would also ensure that the size of a bank subsidiary engaged in new types of financial activities remained modest in comparison to its parent bank. In short, given these constraints, the organizational format for conducting nonbanking activities in either a subsidiary or an affiliate is irrelevant to the subsidy issue, and the subsidy issue is no reason to deny larger banks and non-holding company smaller banks the option to use subsidiaries to conduct expanded types of financial activities.

Ensuring Adequate Consumer Protection is an Essential Component of Financial Modernization

Financial modernization legislation must ensure that the interests of consumers are appropriately protected through adequate disclosure mechanisms and the deterrence of deceptive sales practices. This discussion draft would require the federal banking agencies to issue joint customer protection regulations governing the retail sale of insurance products. We favor this provision as the federal banking agencies have worked together to advise depository institutions to conduct retail sales in a safe and sound manner that protects the interests of consumers. It is not only appropriate but essential for the government to foster an environment in which consumers can evaluate the relative riskiness of their financial choices based on a fair understanding of the products and services available to them.[7] However, we urge that the provisions concerning coordination with state law be simplified so that banks would have more certainty and uniformity in the customer protection provisions that apply to their insurance sales in different states.

Finally, the OCC does not support the discussion draft's "safe harbor" provision regarding the CRA examination process. While this provision reflects an understandable concern about the burdens of CRA compliance, it is likely to increase, rather than decrease those burdens. Faced with the prospect that a bank's "satisfactory" CRA examination rating might foreclose meaningful consideration of CRA issues in an application proceeding, community groups would inevitably focus their attention and efforts on the examination and rating process. Since only a small percentage of applications are protested, while every bank is rated for CRA performance, such a shift in focus would mean that a great many more confrontations between banks and community groups would be likely to occur, and that the examination process would take on aspects of adversary proceedings, thus prolonging the duration and expanding the scope of examinations.[8]

Moreover, if a satisfactory rating were to have the effect of preempting consideration of CRA issues in a subsequent application, it is likely that CRA exams would become more extensive and less efficient, and therefore more burdensome. At present, many CRA exams, particularly those of large banks, combine full scope exams of certain markets with more limited-scope reviews of data from other markets. In an application proceeding, however, it is not uncommon for the agency to scrutinize markets beyond those included in the full-scope portion of the exam. Because the "safe harbor" provision in the discussion draft would preclude consideration of CRA issues in an application proceeding if

[6] The OCC favors applying the following investment constraints, or safeguards: 1) requiring that the bank be well capitalized before making the investment in a financial subsidiary that is engaged as principal in the new types of authorized activities; 2) requiring that the bank deduct from its assets and equity, for purposes of regulatory capital calculation, the amount of the bank's equity investments in a subsidiary (and, correspondingly, the assets and liabilities of the subsidiary are not consolidated with those of the bank for regulatory capital calculation purposes); 3) requiring that the bank remain well capitalized after making this capital deduction; 4) requiring that the bank not make an equity investment in a subsidiary that would exceed the amount that it could pay to its holding company as a dividend, without prior regulatory approval; and 5) requiring that the qualitative and quantitative limitations of sections 23A and 23B apply to extensions of credit to the subsidiary.

[7] The OCC's "Guidance to National Banks on Insurance and Annuity Sales Activities," issued on October 8, 1996 ("advisory") instructs banks to follow proper procedures to ensure customers are able to distinguish between insurance and deposit products. These procedures include making adequate disclosures that an insurance product is not FDIC insured, is not a deposit or an obligation of the bank, and is not guaranteed by the bank. Moreover, the OCC's advisory emphasizes that banks need to ensure that only qualified people are selling insurance, and that insurance is sold in areas that are separate from traditional banking functions, *e.g.*, deposit taking, to the extent practicable.

[8] In the past three years, less than 1 percent of the applications subject to CRA that were filed with the OCC were protested. Specifically, we received protests on 11 out of 3,390 applications in 1996, 14 out of 2,631 applications in 1997, and 6 out of 2,229 applications in 1998. In those years, the OCC assigned CRA ratings to 998, 784, and 490 institutions, respectively.

the parties had satisfactory ratings, the agencies would be under enormous pressure to make a broader and more searching inquiry into the parties' CRA performance at the examination stage, raising a significant question whether the efficiencies involved in combining full-scope with more limited data reviews could be maintained.

Conclusion

In conclusion, let me again emphasize the importance of limiting intervention in financial markets to that which is necessary to protect clearly defined, demonstrable governmental interests, such as maintaining the safety and soundness of the banking system and ensuring that consumers are adequately protected. Our concerns over the current version of the Financial Services Act of 1999 arise from the inclusion of certain key provisions that work contrary to the interests of safety and soundness and may undermine much good work that the CRA has achieved.

[Attachment follows]

Attachment

The OCC's Primary Concerns about the "Financial Services Act of 1999" (February 24, 1999)

1. Expanded Activities Allowed for Bank Holding Companies

Section 102 of the draft "Financial Services Act of 1999" [S. 753] (the draft) would amend the Bank Holding Company Act (BHCA) to permit bank holding companies (BHCs) that satisfy certain requirements to engage in a broad range of activities that are defined as financial in nature or incidental thereto without the prior approval of the Federal Reserve Board (FRB). These new financial activities include *principal and agency* securities and insurance activities, as well as merchant banking. The FRB, in coordination with the Secretary of the Treasury, could by regulation or order add to the list of approved financial activities after taking into account certain factors. Currently BHCs may conduct only activities that are closely related to banking or permitted under another exception in the BHCA. 12 USC 1843.

A BHC would be authorized to engage in the new financial activities only if all insured depository institution subsidiaries were well capitalized and well managed. If a depository institution failed to satisfy these requirements, the FRB could impose limitations on the *conduct or activities* of the BHC or any affiliate, including a depository institution, and require divestiture if it failed to correct the problems within six months.

Thus, in essence, if a banking organization wanted to use any of the new powers authorized for holding company affiliates (and the larger banks and any holding company–owned banks would be *forced* to conduct most new financial activities through a holding company affiliate), the banks in the organization would essentially be opting-in to a new system of prompt corrective action, administered by the FRB, triggered if the bank merely becomes *adequately* capitalized. Banks would be subject to a new set of standards, administered by the FRB, that would involve the FRB ordering and imposing corrective actions if the bank slipped below the well capitalized or well managed standard. Ordinarily, the bank's *primary regulator* imposes remedial requirements if the bank ceases to be *adequately* capitalized. In addition, banks would be subject to additional costs to conduct these new financial activities through holding company affiliates that might not be present if the activities were conducted in a bank subsidiary.

2. Activities Permitted for Subsidiaries of National Banks

Section 122 of the draft would amend the National Bank Act to allow small national banks that have total assets of $1 billion or less and that are not affiliated with a BHC to conduct *principal and agency* activities through *wholly* owned subsidiaries if the activities were financial in nature or incidental to financial activities (except real estate development). Larger national banks that had total assets of over $1 billion and community national banks that are owned by a holding company could engage in new financial activities through a *wholly* owned subsidiary only on an *agency* basis. The financial activities could be conducted in a subsidiary provided that the national bank and all insured depository institution affiliates were well capitalized and well managed and the bank receives the approval of the Comptroller.

If the subsidiary were engaging in financial activities as principal (and only smaller national banks that are *not* part of BHCs would be permitted to conduct new financial activities as principal under the draft), other safeguards would apply. The bank's equity investment in the subsidiary would have to be deducted from the bank's assets and tangible equity and the subsidiary's assets and liabilities could not be consolidated with the those of the bank. Thus, the bank would have to be well capitalized before and after its investment in the subsidiary. In addition, the operational requirements in section 23B of the Federal Reserve Act (FRA) would apply. Finally, Section 122 would prohibit a subsidiary of a national or state bank, or a thrift, from engaging in new securities underwriting of bank impermissible securities after September 15, 1997. Foreign banks would be specifically exempted from this prohibition.

The proposal would have the perverse result of denying the larger national banks and all holding company–owned community banks in the national banking system the safety and soundness benefits of using a subsidiary to conduct expanded new financial activities. These are the institutions that control the overwhelming majority of assets held in the national banking system.

- Requiring larger banks and all holding company–owned community banks to use an organizational structure for conducting expanded financial activities would weaken them by forcing them to use their resources to capitalize and fund holding company affiliates rather than husbanding those resources in the bank. This would increase the exposure of the bank to credit risk and credit concentrations in their traditional lines of business. This provision would be particularly damaging in the case of larger banks, which are the very institutions whose instability could have the most unsettling systemic effects, and whose failure could be the most costly to the Federal Deposit Insurance Corporation (FDIC).

- Limiting larger national banks and holding company–owned community banks to conducting expanded activities in subsidiaries only in an *agency* capacity would limit sources of revenue that flow to the bank. These banks would be deprived of opportunities to diversify their revenue flows and instead those business opportunities—and revenue—would be diverted away from the bank to holding company affiliates. *State* banks would not be subject to comparable restrictions.
- Requiring all national banks that conduct expanded financial activities to use a *wholly* owned bank subsidiary would prevent national banks from using joint ventures or joining consortia to engage in the expanded activities. This restriction could particularly impact community national banks that want to engage in the new financial activities but do not have the resources or the customer base to support a *wholly* owned subsidiary. For example, community national banks could not join together to jointly own an insurance agency subsidiary that was based outside a "place of 5,000." No similar requirement would apply to *state* banks.
- Permitting foreign bank competitors to use subsidiaries to conduct expanded financial activities in the United States while barring the same option for our largest national banks and a substantial portion of our community banks would create an unlevel playing field. U.S. banks would be hobbled by provisions that unnecessarily restrict their options, flexibility, and efficiency. *Foreign* banks would not.

Moreover, the risks to the bank from activities conducted in a subsidiary are no greater than if the activities were conducted in an affiliate if the equivalent safeguards are imposed. In addition, with the equivalent safeguards in place, the leakage of any net subsidy (if one exists) will be contained to the same extent as if the activities were conducted in a BHC affiliate. The equivalent safeguards that we recommend include: (1) restricting the bank's equity investment in the subsidiary to the amount a bank could dividend to its parent bank holding company (unless the regulator permits a greater investment), (2) further limiting the size of the subsidiary by deducting the bank's investment in the subsidiary from the bank's capital and requiring the bank to remain "well capitalized" after the deduction, and (3) imposing the same limitations that are in sections 23A and 23B of the FRA to loans and other extensions of credit between the parent bank and the subsidiary that apply to transactions between the bank and its holding company affiliates.

3. Supervision and Regulation of Holding Companies

Section 114 of the draft would prohibit the appropriate federal banking agencies (AFBAs) from examining or inspecting any registered investment company that is not a bank holding company or a savings and loan holding company; only the FDIC could do so if necessary to determine the condition of an insured depository institution for insurance purposes. The Securities and Exchange Commission (SEC) would provide the AFBAs with the results of an examination of registered funds upon request. This prohibition would apply to common and collective funds that are *part* of the bank and that also may be registered investment companies. Thus, this provision would prevent the AFBAs from performing the examinations required under existing law and would undermine our authority to assess the safety and soundness of funds maintained for fiduciary purposes by depository institutions that have been registered as investment companies. With respect to these types of funds, the SEC and the AFBA for the bank both have responsibilities and neither should be displaced.

4. Preemption

Section 104 of the draft would provide that state law may not prevent or restrict the affiliations authorized under this legislation. In addition, state law could not prevent or restrict an insured depository institution, or a subsidiary or affiliate thereof, from conducting activities authorized by the draft if the practical effect of the state action were to discriminate against the institution, or its subsidiaries or affiliates based on their affiliation with the institution. These rules would not affect the jurisdiction of the state securities commission to investigate and bring enforcement actions consistent with the federal securities laws. These rules also would not affect state actions of "general applicability relating to the governance of corporations" or the "applicability of the antitrust laws of any State or any State law similar to the antitrust laws."

Thus, state laws relating to corporate governance and state laws labeled as antitrust laws would be permitted to "prevent or restrict" authorized affiliations and activities. This is true even if these laws had a disparate impact on banks, their subsidiaries, or affiliates. A state law could be "generally applicable" but still have a disparate impact on a bank as compared with its effect on companies that are not banks or affiliated with banks. Unfortunately, national banks' experience with some state laws characterized as "anti-trust" laws or some laws related to "unfair methods of competition" is that these laws in many cases are intended to prevent or impede the ability of banks to sell insurance.

5. Bank Securities and Insurance Activities

Section 121 of the draft would authorize well-capitalized national banks and their subsidiaries to underwrite and deal in municipal revenue bonds.

The OCC supports the change in section 121. However, there is nothing in the bill that would repeal the antiquated restrictions on national banks engaging in insurance agency activities. National banks' permissible insurance agency activities are limited in 12 USC 92 to banks that are located and doing business in a place that does not exceed 5,000 in population. This restriction dates from *1916.* Many states permit their banks to sell insurance free from any comparable restraints. Agency activities are substantially riskless and there are no offsetting safety and soundness concerns that warrant restricting national banks to this outdated restriction on their insurance activities.

6. Consumer Protections

Section 201 would require the federal banking agencies to prescribe joint consumer protection regulations that apply to retail sales and advertising of any insurance product by an insured depository institution, its subsidiaries, or employees/agents thereof. This section would also prohibit an "inconsistent" or "contrary" state provision from being preempted by the federal regulations *unless* the federal banking agencies jointly made certain determinations and appropriately considered the comments of the state authorities. If the federal agencies made this determination, notice would have to be given to the states and the preemption would become effective unless the state enacted a law in three years overriding the preemption.

This provision is quite convoluted and presents the troubling prospect that in each state, banks selling insurance would be subject to a different combination of provisions of the federal rules, state provisions that co-exist with the federal rules, state provisions that supersede the federal rules, and state provisions that are superseded by the federal rules. The mix of these provisions could be different in each state in which a bank sells insurance and there is nothing in the provision that would require the state law to be in compliance with section 104. The provision is further complicated by the provision that would give states three years to opt-out of a determination by the federal banking agencies that a state provision is superseded because the federal rule provides greater protection. In any case, the potential combination of state and federal provisions in any given state could be quite burdensome to decipher and to apply. Customer protection would be enhanced with a simplified approach.

7. Community Reinvestment Act

Section 303 of the draft would provide that, if an insured depository institution has received a "satisfactory" rating at its most recent examination under the Community Reinvestment Act (CRA), and it has been found to be in compliance with the requirements of CRA in examinations during the preceding three years, it would be deemed to be in compliance with CRA until the completion of the next regularly scheduled examination unless certain information to the contrary were filed with the AFBA. The information filed with the AFBA would have to be "substantial verifiable information" that arose since the time of the institution's most recent examination under CRA. The person filing the information would have the burden of proving to the AFBA that the information is substantial and verifiable. The AFBA would determine if the information provided sufficient proof that the institution was no longer in compliance with CRA.

The OCC does not support the draft's "safe harbor" provision regarding the CRA examination process. This provision would be likely to increase, rather than decrease, the burdens of CRA compliance. Today only a small percentage of applications are protested but every bank is required to be rated for CRA performance. If community groups believed that they could not raise meaningful issues during the application process, their only opportunity to raise their concerns would be during the CRA examination and rating process. An increased emphasis on the examination and rating process could mean that this process takes on aspects of an adversarial proceeding thereby prolonging the duration and expanding the scope of examinations, and making the examination process more burdensome.

In addition, if a "satisfactory" rating would have the effect of foreclosing the AFBA's consideration of a bank's CRA performance in a subsequent application, the AFBA could be under increased pressure to use more extensive procedures to determine a bank's CRA performance at the time of the examination. Today many CRA examinations, particularly those of larger banks, combine full scope examinations of certain markets with more limited reviews of data from other markets. In the application process, however, it is not uncommon for issues to arise concerning markets beyond those included in the full scope examination. The "safe harbor," thus, could raise significant questions whether the efficiencies involved in the current examination process could be maintained.

We also note that there is nothing in the legislation that would require depository institutions that are part of BHCs, or banks seeking to engage in expanded activities through subsidiaries, to have and maintain at least a "satisfactory" CRA rating. The OCC supports the approach taken in the House-passed version of H.R. 10, which would apply a satisfactory CRA requirement on an on-going basis as a condition to engaging in the new financial activities.

Remarks by John D. Hawke Jr., Comptroller of the Currency, before the Institute of International Bankers, on strengthening international financial supervision, Washington, D.C., March 1, 1999

More than 200 years ago the founders of this country first presented an overwhelmingly hostile world with the idea of a commercial millennium based on three pillars: free trade, non-discrimination, and peaceful competition.

Many organizations and individuals since then have dedicated themselves to that cause. Since 1966, the Institute of International Bankers has vigorously defended the right of international banks operating in the United States to enjoy the same commercial opportunities available to domestic institutions. For the Office of the Comptroller of the Currency, the struggle has been to ensure that the national banking system can adapt freely and fairly to the continuing innovations in financial services—once again, without preference or discrimination.

As we approach the new millennium, I believe we're closer than ever to realizing the vision of America's founders. Barriers are crumbling. Openness and integration are being increasingly embraced. The perils of protectionism and discrimination are better understood than ever. So are the benefits of competition and access to the global marketplace for capital, customers, and ideas.

It goes almost without saying that, for domestic as well as foreign bankers, the global environment holds risks as well as rewards. We've had quite a few blunt reminders recently: economic turmoil in Asia, Latin America, and Eastern Europe, and closer to home the near-collapse of a giant hedge fund that, among other things, took unwarranted risks in foreign currency trading. Each of these situations produced big losses for a small number of large U.S. commercial banks. They also raised compelling questions about the stability of the international economic order.

No one can be certain where the next trouble spot will be. Certainly there's no shortage of candidates and scenarios. Volatility in financial markets is something we must now take for granted. Technology—a blessing in most respects—virtually guarantees it. The year 2000 looms on the horizon. The speed with which news can now travel makes for hair-trigger market responses. Investors can react instantly—and just as easily overreact—to events halfway around the world.

It's a certainty that economic crises will occur in the future and spill over national borders. The challenge is how we go about managing and containing their impact. That's the question I'd like to discuss with you this morning.

Both within our own countries and in cooperation with our colleagues around the world, financial supervisors bear a major part of the front- line responsibility for preventing financial crises and for managing them, when they do occur. Most analysts agree that supervisory errors—of omission *and* commission—were at least partly to blame for the financial difficulties from which many of the economies, of East Asia in particular, are still striving to recover.

It seems clear that a more robust, independent, and proactive supervisory presence in those countries would have mitigated, if not averted, some of their problems. Just as clearly, supervisory vigilance beyond the afflicted countries has played an important role in keeping the Asian problem from spreading beyond the Pacific Rim to other shores.

As I've already said, banks in the United States and elsewhere have not been unaffected by the fallout. Many did not appreciate the extent of their vulnerability to these external shocks. Banks that may have viewed themselves as too small or too isolated to worry about such distant developments have had a painful lesson in the reach of the new global economy.

Let me give you just one example. In fiscal 1996, U.S. farm exports were worth just under $60 billion. For 1999, the total is expected to be in the neighborhood of $49 billion, with more than 80 percent of the decline attributable to the problems in East Asia. The result, predictably, has already been a small increase in the number of problem loans to afflicted farmers. Even more importantly, we have seen a dramatic increase in problem loans to those who depend upon spending by farmers for their own livelihoods.

Larger banks may have understood in advance the risks of foreign lending, foreign currency trading, and lending to domestic customers whose fortunes were intertwined with those of emerging Asian economies. But foreknowledge of the risks has not made the losses they've suffered any less painful to their pride, their bottom line, or their reputation with investors.

It's important, however, that we not lose sight of the fact that, despite many dire predictions to the contrary, such losses have not, to date, compromised the overall safety and soundness of our banking system or that of other major countries outside of Asia. That's itself partly a by-product of globalization and diversification.

With their loans and investments so widely dispersed over product and place, and the growing importance of fee income generated by new products and services, commercial banks in this country seem more resilient and more resistant to sectoral downturns than at virtually any time in their history.

Many have taken a portfolio approach to managing risk: riskier loans and investments are offset with safer ones to produce an overall profile suitable to the institution's own appetite for risk. And they have adopted advanced systems that enable the risk of individual loans within the portfolio to be more accurately measured, monitored, and priced.

For example, robust risk management systems today include provisions for stress-testing loans—that is, subjecting them to a variety of hypothetical adverse scenarios. Stress-testing provides bankers with insights into the levels of risk threatened by various changes in the economy, which they can then use in evaluating total risk exposure.

While bankers themselves deserve most of the credit for their apparent success in weathering the international storms, bank supervisors, as I've suggested, have not been mere bystanders in this process. In some respects, the principles of bank supervision—and banking itself—are not fundamentally different today than they were 30 years ago, at the dawn of the global economy.

The most successful bankers have always been those who excelled at the business of managing risk. For their part, bank supervisors have always been in the business of developing and applying prudential rules to help control those risks, regardless of the size or business focus of the bank to which they pertain.

Today, those rules cover examination of capital adequacy, loan loss reserves, asset concentrations, liquidity, internal controls, and risk management itself. This list of concerns represents an expansion—but not by much—of the supervisor's traditional repertoire.

But supervision today is certainly more sophisticated and—shall I say—more *worldly* than it was three decades ago. Assessing risk in internationally active institutions with complex corporate structures and diverse product menus often involves evaluating activities and processes taking place around the globe and in related corporate entities. Supervision across borders—and across functions—requires collaboration with other supervisors who may not share the same legal mandate or operational philosophy or even speak the same language.

One highly significant change in our approach to supervision involves the growing emphasis on qualitative assessment of bank management and its information and control systems. Experience has repeatedly taught us that numbers alone do not tell the whole story of a bank's health. In fact, in some circumstances, such numbers can be quite misleading. A growing global economy can make bad credit judgments look good.

An abundance of liquidity in the marketplace, bringing increased competition for loans, has caused some banks to relax established standards and in some cases to take foolish risks. We know two things from experience. First, economic conditions inevitably change. And second, compromises and concessions made in good times have a likelihood of increasing losses when times change.

That's not to say that banks should not strive to be competitive. Prudent risk-taking that's based on good information and is understood by management and given proper oversight is the essence of the banking business.

But risk-taking in an information vacuum, based not on sound credit judgments but on the stylishness of the borrower, can never be prudent. Any loan officer who asks a "hot" borrower for financial information only to be told "we never give that out," should walk away from the credit. Advancing hundreds of millions of dollars without adequate information simply because other creditors may be scrambling to provide funds to some group perceived as market geniuses, is not prudent lending. It's Russian roulette.

Moreover, it's one dangerous game whose potential risks are not limited to those seated at the table. As we have seen, in an increasingly interconnected world, private financial decisions can have far reaching public consequences. And that demands a multidimensional—and multinational—approach to financial supervision.

On the one hand, we must all work to promote the adoption of fundamental supervisory principles in those parts of the world where they have not been adopted already. On the other hand, supervisors must be endowed with sufficient discretion to accommodate the wide range of variations in business strategies and structural arrangements under which financial institutions operate in the real world. And, finally, provision must be made for more regular, ongoing dialogue *between* supervisors than ever before.

That's a daunting challenge. Yet progress is being made on several fronts. The adoption in October 1997 of 25 "core principles for effective supervision" by the Basel Committee on Banking Supervision was a major step in this direction.

The Basel core principles, which codify prevailing supervisory practice in the advanced nations—particularly (though not exclusively) the United States—embody an important assumption: that banking crises stem from common causes, whether they take place in industrialized or developing countries. In other words, the principles of effective supervision and the principles of sound lending—principles that have withstood the test of time and experience in the United States and elsewhere—are likely to apply to financial institutions everywhere.

It's encouraging to me that the core principles—and the assumptions on which they're based—are being rapidly embraced in the non–G–10 world. At last year's International Conference of Banking Supervisors in Sydney, Australia, supervisors representing 120 countries gave the core principles a ringing endorsement. The Basel Committee continues to issue guidance elaborating on the core principles.

This activity has been matched by activity on other international fronts. Just in recent months, the G–7 heads of state and finance ministers have gone on record reiterating their calls for strengthened supervision, increased information exchange between and among functional and national supervisors, and improved transparency and accountability.

Similar calls are made in papers released by the so-called G–22, which included emerging market countries along with the G–7. Two weeks ago, the Joint Forum on Financial Conglomerates, a cooperative body of banking, insurance, and securities supervisors, issued a set of papers on principles for supervision and information exchange.

One recent illustration of the critical importance of these cooperative, cross-industry, and cross-border efforts is the work being done to promote international Y2K readiness. The mechanisms for multilateral communications developed for that purpose should prove useful in promoting enhanced dialogue on the whole range of supervisory issues in the future.

Of course, there's a world of difference between commitments to action and action itself. We have no illusions that each of the countries that subscribed to the Basel core principles are in a position to fully implement them in the near future. We are not even certain about what constitutes adherence, although a joint task force consisting of representatives from the Basel Committee, the International Monetary Fund, and the World Bank is even now wrestling with that question and with developing ways to measure progress.

Certainly, serious obstacles remain to be overcome. The international supervisors who assembled at Sydney last year spoke very nearly in unison, but they were not always authorized to fully commit their governments. The degree to which political leaders will provide the resources, operational independence, and moral support to their own bank supervisors is sure to vary dramatically across the spectrum.

We will also need to enlist the cooperation of other interested parties, such as the bodies that set accounting standards. But one hopes that self-interest and the lessons of recent history will convince leaders around the world—and financial institutions themselves—that, in the new integrated economy, there is no viable alternative to strong, professional financial supervision.

Conclusion

The crises in international finance that we've undergone in recent years have certainly been traumatic. They've caused hardships for millions of people and set back development in parts of the world that desperately need it.

Unfortunately, we sometimes learn best from the hardest lessons. Upheaval and dislocation have driven home the basic fact that healthy banking systems are a prerequisite for sound national and global economies. Financial instability has proved the importance of effective supervision. Let me close by emphasizing my belief that it's in your interest, as representatives of non-U.S. banks in America, to support the efforts I've described to strengthen financial supervision worldwide. No one has more to gain from effective international supervision than the financial institutions that operate under its umbrella. Conversely, no one has more to lose when financial supervision goes awry, as events in East Asia demonstrated.

Strengthening international financial supervision is one important means of providing for a safe and sound banking system and a prosperous international economy. I encourage you to join in that effort.

Statement of John D. Hawke Jr., Comptroller of the Currency, before the Commercial and Administrative Law Subcommittee, U.S. House Committee on the Judiciary, on the proposed "know your customer" rule, Washington, D.C., March 4, 1999

Chairman Gekas, Ranking Member Nadler, and members of the subcommittee, I am pleased to be with you this morning to present my views on the proposed regulation that has come to be called "know your customer."

I was sworn in as Comptroller of the Currency on December 8, 1998, so I did not participate either in the process that led to this proposal, or in the formulation of the proposal itself. I come new to the issue, and this has both advantages and disadvantages.

One clear disadvantage is that I did not have a first-hand opportunity to learn of the background of the proposal before it was published or to benefit from the interagency deliberations concerning the complex issues that unquestionably surfaced as the agencies formulated the proposal.

One advantage of coming new to this issue, however, is that I believe I can bring an objective judgment to the question of what future the proposal should have—a judgment that I hope is informed by some 37 years in the public and private sector of dealing with issues of federal banking regulation, as a lawyer in private practice representing banks, as a professor of banking law at three law schools, as General Counsel to the Federal Reserve Board, and as Under Secretary of the Treasury for Domestic Finance.

Mr. Chairman, the comment period on the proposed regulation closes this coming Monday, and we are reviewing the many comments we have received. It is my judgment, however, that the proposal should be promptly withdrawn. I firmly believe that any marginal advantages for law enforcement in this proposal are strongly outweighed by its potential for inflicting lasting damage on our banking system. I will explain my reasoning.

Let me say at the outset that the law enforcement objectives that underlie the know your customer proposal are of enormous importance to our country and must not be dismissed. It is widely recognized that the ability to launder the proceeds of illegal activity—particularly drug traffic—facilitates criminals engaged in such activity. Stemming the flow of narcotics into the country, and combating the sale of drugs on our streets, depend heavily on the ability of law enforcement to impede the efforts of drug dealers to convert the cash proceeds of their activities into useable funds.

Since it is inevitable that criminals will seek to use depository institutions to launder their illegal revenues, it is entirely reasonable that banks and their regulators take all reasonable steps to ensure that they are not used wittingly or unwittingly to further illegal activities. For many years the Bank Secrecy Act has been aimed at achieving this objective and bankers have provided a valuable role in this effort in a working partnership with bank regulators and the law enforcement community.

Beyond the valuable contribution banks make to this effort, there are other considerations that must be weighed as we consider new regulatory initiatives. Banks play an enormously important role in our economy. They serve as a safe repository for the earnings and savings of scores of millions of citizens. They play an essential role in the financing of commercial and consumer transactions. They operate our mechanism for making and clearing payments, and they provide a broad range of fiduciary services for both individuals and businesses.

Maintaining public confidence in the banking system has long been an important objective of national policy. That is why Congress created a system of federal deposit insurance 65 years ago; it is why the Federal Reserve has been invested with the responsibility to act as a lender of last resort and provider of liquidity; and it is why we have a comprehensive system of federal bank licensing, supervision, and regulation. Indeed, restoring public confidence in banks was one of the important reasons why the OCC was created over 135 years ago.

Crucial to maintaining the confidence of bank customers in our banking system is their expectation that their relationships with their banks will be private and confidential—that information they provide to their banks will not be used for inappropriate purposes; that transactions will be processed objectively and nonjudgmentally; and that the interests of the customer will be paramount in importance. As I learned early in my legal career, many courts have held that banks have an implied contractual obligation of confidentiality to their customers.

To be sure, this confidentiality is not absolute. Banks must respond to lawful subpoenas for customer information; they have reporting obligations under the Bank Secrecy Act; they are required to report "suspicious transactions" to law enforcement authorities; and they may share certain kinds of information about credit experience with credit reporting bureaus. To date, however, these qualifications to customer confidentiality have not seriously affected customer confidence in the system as a whole—although, as I will point out shortly, they have created enough concerns to keep millions of Americans out of the system.

My grave concern is that if federal law imposes an explicit and enforceable obligation on banks not only to adopt procedures designed to identify their customers, but also to maintain systems for “monitoring customer transactions and identifying transactions that are inconsistent with normal and expected transactions” for that customer, as the proposed regulation would require, it could have a profoundly adverse effect on the nature of the relationship banks have with their customers, and, consequently, on the banking system as a whole. Law-abiding citizens—who make up the overwhelming proportion of bank customers—are likely to have serious concerns that their everyday relationships with their banks will be routinely scrutinized for evidence of misconduct. They will be understandably apprehensive that their banks will report any transactions that may be the least out-of-the-ordinary, or that don’t meet some predetermined customer “profile” established by a faceless bank employee or some computer program, as a “suspicious activity.” And they are likely to come to the view that instead of being protectors of a confidential relationship, their banks have turned into an extension of the law enforcement apparatus. Were this to occur, it could do lasting damage to our banking system.

There are several other reasons why I have concerns about the proposed know your customer regulation.

First, it would obstruct our effort to bring more Americans into the financial mainstream. In my time as Under Secretary of the Treasury, we worked hard to carry out the mandate of Congress that all federal non-tax payments should be made electronically. One of the greatest obstacles to achieving this goal has been that an estimated 10 million people who regularly receive federal payments do not have bank accounts. There are a variety of reasons why this is so, but surveys indicate that almost one-quarter of those recipients who do not have bank accounts cite confidentiality as a reason. A federally enforced “know your customer” rule can only serve to heighten the concerns that already cause millions to remain outside the banking system.

Second, I believe that the proposal would create competitive disparity among different types of financial service providers, to the detriment of banks. No regulation has yet been proposed that would apply to credit unions, money market mutual funds, and security brokerage accounts. It can be expected that customers who have concerns about the continued confidentiality of their financial affairs may migrate to these other institutions. Indeed, in an open marketplace one might expect those nonbank intermediaries to exploit this advantage.

Finally, I have serious concerns about the kind of regulatory compliance burdens that would inevitably develop if a new regulatory regime were adopted. Bankers have been conditioned to want certainty and precision in the rules they must operate under. I see the potential for a myriad of questions being raised, resulting in the development of a smothering body of rulings and interpretations that banks would have to consult in order to be sure they were in conformity with the law. The creation of such burdens would have a particularly heavy impact on community banks, which typically do not have the depth of compliance resources that larger banks have.

Indeed, the rulemaking proposals themselves give a forewarning of this. While the text of the proposed rule itself is quite short, the preamble material strongly suggests that there will be a strong demand for definition and interpretation. One agency’s proposal, for example, prescribes what kind of customer identification should be required by a bank when a new account is opened. An in-state driver’s license is acceptable, it says, but an out-of-state license cannot be used without “corroboration”—unless the customer happens to live in a community such as Washington, D.C., that spans several states and the license was issued by a “neighboring” state. How long will it be before a banker asks for a ruling whether an *expired* driver’s license suffices, or an interpretation whether a state must be contiguous to qualify as “neighboring”?

None of these concerns should be taken as reflecting a belief that banks should remain oblivious to the identities of their customers or that they should not take care to have systems and controls in place that will allow them to identify suspected illegal conduct—such as transactions that are purposely structured to remain below reporting thresholds. Banks not only have obligations under existing law, but they have a variety of good business reasons to know their customers. The large majority of banks already have processes in place to accomplish these objectives.

In that regard, bank trade associations could provide a valuable service to their members by developing and sharing information on best practices in this area. Trade groups do an effective job in communicating their members’ objections to proposed government initiatives, but there is an opportunity here for them to address the know your customer issue in a way that could obviate the need for any new regulation. Assisting members in developing sensible and customer-sensitive know your customer programs would be a valuable service.

For all of the reasons I have expressed in my statement to you today, I am convinced that this proposal should be withdrawn. Thank you for the opportunity to address this important matter.

Remarks by John D. Hawke Jr., Comptroller of the Currency, before the Independent Bankers Association of America, on new initiatives in supervising community banks, San Francisco, California, March 17, 1999

I've come to San Francisco to talk to you this morning about a subject with serious implications for the banking business: the snail darter. You may recall the snail darter as the little fish—three inches long when fully grown—that earned a place on the endangered species list and the national agenda a few years back when construction projects on the Tennessee River were halted to protect the darter's dwindling habitat.

I mention this because of a magazine headline I recall from those days. It asked the question: "What do community banks and the snail darter have in common?" Here's how I would respond: if the snail darter's prospects are as bright today as those of our community banks, then conservationists can rest easy.

In fact, the latest reports from Tennessee are reassuring. There's talk of removing the fish from the endangered list. Yet, even if the river were to grow thick with snail darters, I suspect the impression would persist in the outside world that this was a species in trouble—just as some continue to wring their hands about the future of community banks. Perception can be slow in catching up to reality.

The reality is that, by nearly every measure we use to evaluate financial institutions, community banks have never been healthier. Consolidation throughout the banking industry makes the headlines, but the small print reveals that new banks are being created at a healthy rate. More than 600 new banks have been chartered in the last five years.

Many of these, in fact, are the consequence of megamergers. It frequently occurs that experienced bankers who have been "separated" in large combinations will organize groups to seek new charters in the very communities affected by the mergers. Clearly, a great many bankers and investors think it's a great idea to own a small bank.

And, judging by the way community banks have performed, one can see why. Last year, community banks as a group had the best return on assets of all commercial banks. Compared to megabanks, they had higher capital ratios, better return on equity, and less earnings volatility, due in part to rising non-interest income. Community banks have also registered impressive gains in efficiency, thanks to technological innovations, streamlined operations, outsourcing, alliances with other community banks, and staff productivity improvements. And all the evidence suggests that you've gained these efficiencies without compromising customer service.

Obviously, community banks are doing many things right. You're not only supporting local economies in the way community banks always have, but you're also doing something less tangible but no less vital: promoting the values of thrift and industry and mutual self-help. The things you stand for are as important as anything you do for your customers.

Community banks fill a critical role in our economy, and nowhere more so than in the small business market. Nobody today would challenge the proposition that small business is crucial to America's economic health. Small firms produce two-thirds of all new jobs, 51 percent of the private gross domestic product, and twice as many product innovations per employee as larger firms.

For some reason, the fact is often overlooked that community banks are small businesses themselves—making the same vital economic contributions as any other small business. But they are also a financial lifeline to the rest of the small business world. It's a natural partnership—after all, who understands the small business person's problems better than another small business person? That relationship can make the difference in determining whether creditworthy small businesses get the funding they need. The close relationship community bankers have with their customers gives them critical information for pricing and lending decisions.

And for the smallest of small businesses, community banks are often not only the best choice, but the *only* choice for loans and other financial services. Consider this: community banks represent only about 4 percent of the assets of all lenders to small businesses. But they make 12 percent of all small business loans and 20 percent of small business loans under $100,000. Clearly, community banks make a disproportionately great contribution to the well-being of small business in our country.

For that reason—and a host of others—community banks are also vitally important to the OCC. The vast majority of the banks we supervise—more than 2,000 of the 2,500 banks we're responsible for—have assets under $1 billion. Moreover, more than 1,300 examiners out of our total examination force of 1,900—68 percent—are assigned to community bank supervision.

However, judging from what I sometimes hear, there seems to be a perception that the OCC is less interested in the needs of community banks than of large banks, most of which have always operated under OCC supervision. If such a perception exists, we need to dispel it. It is simply not supported by the facts.

On the contrary, not only do we have a major commitment of resources to community banks, but I believe that our community banks have found OCC supervision to be supportive of their own business strategies and objectives and conducive to their success. For 136 years, the OCC has sought to provide the highest quality supervision in the world—supervision sensitive to the needs of not only large banks, but small banks as well. Encouraging and supporting small banks—by recognizing their strengths and needs—is an important part of our mission and our tradition.

The OCC's approach to community bank supervision has evolved in response to the experiences of many years. It's based on a judicious combination of on- and off-site activity conducted by locally based examiners and front-line supervisors who know the lay of the land in the communities where our banks operate. It's backed by the strength and depth of a national organization of professionals dedicated *exclusively* to the interests of a safe, sound, and competitive banking system.

To emphasize our concerns for community banks, we recently reorganized our supervisory operations into two "lines of business"—community and mid-sized banks, on the one hand, and large banks on the other—so that we can better meet the unique needs of both. We now have six district offices and 58 field offices dedicated to the supervision of smaller banks, while supervision of the very largest banks has been centralized in Washington.

Our district deputy comptrollers and their staffs—attorneys, analysts, licensing experts, and examiners alike—are committed to providing top-quality and timely service. That includes frequent outreach with community bankers, rapid turnaround in processing corporate applications and responding to inquiries, and minimizing the burden of our policies. In each of our districts, we also have experts in the areas of credit, compliance, capital markets, BIS [bank information systems], asset management, community reinvestment and development, and fraud—all available to assist you and respond to questions you may have.

Our basic approach to community bank supervision embodies what we call "portfolio management." Each OCC examiner is assigned a portfolio of institutions for which he or she has ongoing responsibility. This approach is designed to provide a high degree of supervisory continuity and to ensure that examiners bring the necessary understanding of each bank's special circumstances to all supervisory activities.

On-site examinations of community banks are conducted on a 12- to 18-month cycle, using procedures developed especially for community banks. These procedures take a risk-focused approach that allows for streamlined, efficient examinations. We focus on practices and outcomes—an approach designed to get examiners in and out of the bank as quickly as possible with the information that both the examiners and bankers need in their work.

But OCC communication with community bankers doesn't stop between examinations. Our practice is for the portfolio manager to use call report data and other information to keep up with the bank's progress on a quarterly basis. Portfolio managers also contact bank management between exams to address current trends and topics, to follow up on issues identified during quarterly reviews or previous examinations, to discuss the bank's future plans, and to share best practices—that is, what your peers are doing that's worthy of emulation. This way, the examiner stays in regular contact with the banks in his or her portfolio, assists bankers in addressing nettlesome issues early on, and prevents little problems from developing into big ones.

While I'm on the subject, let me say a few words about our examiners. I've dealt with them for many years; I've talked with a great many bankers about their quality and performance; and over the last four months I've come to know a great many of them personally. In my view, OCC examiners are second to none. They are dedicated and hard-working, they have the most sophisticated technological tools at their disposal, and they receive the most advanced continuing education in the business. Hundreds of them have achieved industry certifications—in accounting, financial planning, information systems, regulatory compliance, financial analysis, or fraud detection. Thus, they bring not only great experience, but a high level of expertise to their work.

Standing at the ready behind each of our examiners is also a wealth of technical expertise—not only in our district offices, as I described a few minutes ago, but in our headquarters, as well. In addition to our district experts, our supervision policy unit in Washington develops cutting-edge guidance on emerging risks, on new products, and on in-depth examination procedures for specific banking activities and risks. Already this year, we have issued guidance on agricultural credit and subprime lending—two subjects of concern to many community bankers.

In addition, every day, our legal department does battle in defense of your right to operate in a free and fair marketplace—with a very high success rate, I might add—while our staff of professional economists carefully monitors developments throughout the nation and around the globe to identify trends and events that can affect you and your business. I believe our community banks have the best of two worlds: they have expert and highly responsive examiners at the local level, who know their needs and challenges; and, backing up the local portfolio managers, they have the resources of a strong national organization providing support, coordination, and effective representation of their interests.

Even before I was sworn in as Comptroller, I had in mind that an early focus on the needs of community banks would have to be a top priority if I were to assume this office. Last summer I raised the subject with Ken Guenther, who has been a friend and a colleague for over 20 years, since our days together at the Federal Reserve, and who regularly keeps me informed on your concerns. When the invitation came to address you today, I saw it as an opportunity to talk to the community bankers of America about the OCC's commitment to their interests.

To that end, I'm announcing today a series of steps we'll be taking immediately and in the coming months designed to improve the quality of the service we deliver to community banks. These actions fall into three broad categories: outreach, information resources, and regulatory review.

As I mentioned earlier, regular and open communication between examiners and bankers is already an important element in the OCC's overall approach to community bank supervision. In recent years, we have expanded channels of communication to include meetings between bankers and the Comptroller, and between OCC groups working on specific issues and the affected elements of the banking industry.

For example, we recently formed an Agricultural Working Group, in part to serve as an intermediary between the OCC and agricultural bankers. The outreach activities in our districts have been extensive and varied, including not only forums and seminars for bankers and bank directors, but one-on-one meetings, as well. We have put on programs on such topics as credit underwriting and administration, interest rate risk management, liquidity planning, Y2K [year-2000] contingency planning, general economic conditions, compliance and fraud detection, current legal issues, internal controls, and capital markets.

These programs are tailored by our district and field offices to the needs of the banks they work with. The feedback we have received has been highly enthusiastic. Bankers tell us that these sessions are educational and informative, and help to create a good working relationship between examiners and their banks. They also promote the exchange of views on relevant supervisory issues, and help to ensure that industry input is obtained before we adopt or revise relevant supervisory policies.

I intend to expand these efforts in order to assure that we are being fully responsive to the needs of our banks. To that end, I've asked our district deputy comptrollers to invite community bankers to take part in a series of roundtable meetings, to begin in the third quarter of this year. I will personally participate in as many of these as I can. I want to hear directly from you about what we're doing well and what we could be doing better. With that feedback, we can take the necessary steps to strengthen even further our outreach program and to make our community bank supervision even better.

The second broad category of new activity is information technology. The OCC is committed to using modern information technology to improve the examination process and help community banks stay safe, sound, and competitive. We see technology as offering a means to ease regulatory burdens and to bring useful information and services to community banks, and we will be exploring how we can share these resources with you.

For example, many community bankers tell us that they would like to be able to compare their performance with that of other banks they see as comparable. We're working on making available to our community banks, at no cost, a simple and user-friendly Internet-based system that will enable them instantaneously to design their own peer groups and retrieve relevant performance data. Using that system, they will be able to compare their own performance with the banks they believe are most relevant for them. This is just the first in a series of enhancements to our information systems that we will be delivering—through your examiner and over the Internet—in the coming months.

The third undertaking I'm announcing today is a community bank–focused review of our regulations and the way they affect community banks. Banking law, of course, is frequently complex, and the regulations that grow out of those laws—individually and cumulatively—can be particularly onerous for community banks, whose resources, understandably, are considerably less than those of large banks that maintain extensive compliance staffs.

Going forward, in all of our rule making, we will first do an internal analysis of the way in which any proposed new rule would affect community banks—a community bank impact analysis, if you will. Then, when we publish a proposal for comment, we will request specific advice from the public on the likely impact of our proposals on community banks.

We are already working at identifying specific regulations that might be changed to give community banks new opportunities for profit and growth without jeopardizing their safety and soundness. For example, we will soon codify recent interpretive rulings permitting community banks to avail themselves of reverse stock splits in order to reduce the number of their shareholders, so as to allow them to take advantage of Subchapter S status.

I look forward to hearing from you with additional suggestions on areas where our rules could be modified or streamlined to lift unnecessary burdens on community banks. I've heard several areas mentioned already, such as the complexities of capital calculations and the need for flexibility in corporate procedures.

We have also heard complaints about competitive disparities caused by national banks' lending limits. This is a subject we need to study more fully, and to that end we will soon be soliciting comment on how we might provide greater flexibility in that area. I am eager to hear what you have to say about that and other issues.

The initiatives I have just described represent a down payment on a promise I am making to you here and now: to do everything in our power while I am Comptroller to ensure that OCC supervision is responsive to your needs as community bankers. And responsiveness includes being sensitive in Washington to the way we communicate with you.

For example, we and the other banking agencies send out scores of communications to banks every month—circulars, bulletins, notices, advisories, alerts, and so on—most of which are addressed to the chief executive officer [CEO]. They frequently say that "senior management" should do thus and so, or assure this or that. We tend to forget that in a great many community banks, there may be only 15 or 20 employees, and that the CEO is all the bank *has* in the way of "senior management." One CEO of a small national bank recently calculated that during 1998 his bank received some 336 such communications. He had to read each one personally to determine whether or not it conveyed information relevant to his bank.

There's a lesson here. The OCC and the other banking agencies communicate a lot of important information in this fashion, but we have to be sensitive to the burdens we place on small banks, which don't have vast legal or compliance staffs to screen, analyze, and develop responses to the materials we routinely send out.

As tangible evidence of our commitment to responsiveness, I am announcing today the creation of a new high-level position in the office of our senior deputy comptroller for Bank Supervision Operations—a director of Community Bank Activities, whose responsibility it will be to help coordinate our efforts to reduce burdens and make our supervision even more useful for community banks. The director will assist in identifying community bank issues and help propose courses of action for the agency, and will be responsible for assuring that our district deputy comptrollers are getting the support they need in their outreach efforts to community banks.

The new director will also head a standing working group having broad representation of those components of the OCC involved with issues that may be relevant to community banks. It's important to keep in mind that community-based institutions operate today in a global and national marketplace. Although your orientation may be local, distant events continue to affect the climate in which you do business. The working group will also allow us to promote wider dissemination of best practices and lessons learned *across* our districts.

Needless to say, we can't alleviate all of the concerns of community banks. In some cases, action by Congress is needed. We operate under a legal framework that is in some respects outdated and in others simply unfair in its treatment of banks. For example, as you know, the environment in which banks and other financial service providers operate is fiercely competitive. Yet, every day in the marketplace you face stiff competition from credit unions, which act a lot like banks, but don't pay taxes on their earnings. While Congress may be reluctant to address this issue, we cannot afford to simply let it fade away. The competitive inequity that favors credit unions at the expense of small banks *must* be addressed.

We also hear from many small banks that they are under liquidity pressures today, and that these pressures may have an impact on their ability to continue to serve the credit needs of small businesses. Expanding access for community banks to the resources of the Federal Home Loan Bank System would help to relieve such pressures, and I am pleased to say that the Administration has supported doing just that as part of a broader legislative reform of the Home Loan Bank System.

Notwithstanding the many challenges you face, I believe that you—the independent community bankers of America—can approach the 21st century with great confidence. Certainly there will be change and challenge. But your primary stock in trade—your familiarity with the needs of your customers, your responsiveness, and your personal service—will never go out of style. Preserve the essential qualities of adaptability and responsiveness that have been your hallmark for decades, and it's your competitors who may become the snail darters of the future.

Remarks by John D. Hawke Jr., Comptroller of the Currency, before the National Community Reinvestment Coalition, on access to financial services, Washington, D.C., March 19, 1999

Most of the papers you hear at academic conferences don't cause much of a ripple. Back in 1893, a young professor of history named Frederick Jackson Turner delivered one that did. His piece was titled, "The Significance of the Frontier in American History," and it offered the theory that the challenge of subduing the North American continent had decisively shaped America's institutions and national character. But what made Turner's paper a public sensation was another point: that with the frontier era all but over, Americans in the 20th century would need to find new outlets for their restlessness and creative energies.

Turner's thesis made many Americans uneasy about the coming century. But it wasn't long before new frontiers beckoned: in science and technology, culture and the arts, and in improving the lot of all of our people and creating a more just society. These challenges have proved truly worthy of our best efforts as a nation. Working best when we've worked together, government, the private sector, and nonprofit organizations have made the 20th century a time of tremendous progress toward a richer life for all Americans.

It's also been a century of frontiers in finance. In the 1890s, commercial banks focused exclusively on commercial needs. Until the 1920s, consumer loans were virtually unheard of, and even then, few banks had any interest in making them. As late as the 1950s, there were still bankers who would make an auto loan only on condition that the purchaser turn over the keys and park the vehicle behind the bank until the loan was paid off.

One explanation for this behavior is that bankers did not have the information they needed to make better business decisions. Imbued with the 19th century notion that credit to ordinary people was somehow immoral or at least imprudent, convinced that even middle-class borrowers would not know how to handle loans and that default rates would be high if they received them, most bankers chose to disregard consumers' legitimate credit needs.

But the few who were willing to take the chance were rewarded for their efforts. In fact, during the Great Depression, consumer loans outperformed commercial loans. Based on this experience and the information and insight into customer behavior gained in the process, consumer credit exploded, and has continued to expand to this day.

Today, banks make more home purchase loans, more auto loans, more installment loans, and more credit card loans than any other type of financial institution. They are responsible for the bulk of the small business lending and a major share of the agricultural lending in the country today. As a result, home ownership rates have never been higher; our small businesses have never been more vibrant and innovative; our farms have never been more productive; and our national economy has never been healthier. By reaching out to new customers, banks not only democratize credit; they democratize prosperity, making it more resilient and more stable. And they assure themselves a prosperous business future.

Still, many Americans have been left behind. After World War II, banks followed their most affluent customers from the inner cities to the suburbs. Those left behind were often people with whom bankers were no more comfortable than they had been with middle-class consumers during the earlier era. The decay of central cities, hastened by the lack of reinvestment capital, became a rationale for not providing it. Again, misconceptions and information shortfalls interfered with the realization of market opportunities.

Then Congress stepped in. The Community Reinvestment Act of 1977 was an attempt to close the information gap between financial providers and consumers, to prime the pump, and to give market forces the push they needed to operate on their own in all communities. It was also a law that furthered the public policy of promoting home ownership, with all that implies for improving our standard of living and revitalizing our cities.

As you know, CRA was slow to produce results. But, in an effort that started five years ago, the CRA regulations were revised—very largely, I'm proud to say, through the initiative of Comptroller Gene Ludwig and the OCC. The results since then speak for themselves. Between 1993 and 1998, according to NCRC's [National Community Reinvestment Coalition's] own research, financial institutions have made CRA commitments and pledges totaling more than one trillion dollars. That represents 96 percent of all the CRA commitments made since the law was enacted. That means affordable housing, small business opportunities, retail and community revitalization projects, and a brighter future for tens of millions of Americans. Low- and moderate-income borrowers received 28 percent of all home purchase loans in 1997—up from 18 percent in 1990. And, through their experience under CRA in helping to rebuild communities, financial institutions have learned about new market opportunities that should enhance their bottom lines for years to come.

The expansion of consumer credit and the resurgence of community investment will clearly stand among the signal accomplishments of American finance in the 20th century—accomplishments that attest to the power of the public, private, and nonprofit partnerships that made them possible.

To be sure, we still face serious challenges in both areas. CRA commitments and pledges, though impressively large, still fall short of the needs of our communities. And we're still learning about how best to use these funds to meet community needs. For example, we've learned that making affordable mortgage loans is just one piece of an effective overall strategy to help improve standards of living. But first-time homeowners often need homeowner education and counseling, both before and after the loan, to make the experience a success.

CRA itself is facing change. As it was originally conceived, CRA had a deliberately local focus. It sought to assure that local communities from which deposits were gathered were not ignored when those deposits were put out to work as loans. The emphasis was on serving the local community where the bank was situated.

Because of changes in the law and technology, as well as in the approach to delivering financial products, the original CRA concept of serving the localities contiguous to the bank's offices is under some strain. To a considerable degree, the elimination of geographic constraints on the ability of banks to compete, the evolution of credit card banks doing a nationwide business, and the growing use of the Internet are transforming the relevance of geography where banks are concerned. But these changes cannot and do not relieve depository institutions of the responsibility for meeting CRA obligations. The challenge we face today is how to define and enforce those obligations in the financial services marketplace of the 21st century. We are seriously studying this question. NCRC has been in the vanguard of the thinking on this issue, and your contributions have been challenging and provocative. In response, we have decided to seek public comment on this and related questions, and we look forward to receiving broad input on how we can assure that CRA continues to be meaningful to the credit and financial service needs of all our communities as banking structure and financial services delivery continue to evolve.

These are important issues. But we face new challenges—new frontiers—that must also be addressed. High on the list is the plight of the unbanked and underbanked. According to the latest Survey of Consumer Finances, 13 percent of all Americans households, or 30 million adults, do not have a deposit account at a financial institution. Fifteen percent do not have a checking account. That represents 39 percent of all households with incomes under $10,000, 30 percent of all nonwhite or Hispanic households, and 40 percent of all households whose head is not working. Moreover, 10 million individuals who regularly receive payments from the federal government do not have bank accounts. In other words, the neediest and most vulnerable segments of our population—the people who potentially have the most to gain through participation in the banking system—are currently outside the system. That's simply unacceptable.

There was a time when the decision to operate in the cash economy and to dispense with banks could be defended as involving a reasonable trade-off of costs and benefits. Bank accounts have frequently been viewed by many low- and middle-income families as too costly. Bank branches are frequently fewer and farther between in the communities where they live. Nonbank check-cashers have often moved into such neighborhoods, offering services that are more expensive than those offered by banks. While using a bank account is self-evidently safer than walking around with cash, underbanked families—especially those that live from paycheck to paycheck and spend almost everything they earn—have learned to live without banks.

But the traditional economy is fast becoming yesterday's economy. Fewer and fewer transactions are paper transactions; increasingly, funds move electronically. And, as this technological transformation continues to work its way throughout our society, the inaccessibility of traditional depositories becomes increasingly burdensome and harder to justify. Already, it is virtually impossible to rent a car, buy a plane ticket, or even rent the latest Hollywood release from the video shop without a credit card. As the gap widens between those who are plugged in and those who are not, it will also widen between the haves and have-nots—a possibility with serious ramifications for our country.

The point is that the costs of being unbanked are not borne exclusively by the unbanked themselves. There are consequences to society when some of its members are unable to participate in economic life to their full potential—as when, for example, lack of credit history and a banking relationship makes it next to impossible to obtain a home mortgage or an education loan on reasonable terms.

Society also absorbs substantial added costs in conducting transactions with those for whom the traditional financial system is inaccessible. When Congress required that, starting early this year, all federal payments other than tax refunds be made by electronic funds transfer, EFT '99—as it came to be known—was expected to save millions of dollars for taxpayers, by reducing payment delivery costs to a few pennies per payment. EFT '99 raised the prospect of even further savings for the economy as private payers, following the lead of government, moved to electronic delivery. But the realization of those savings depended in large measure on recipients having access to a bank account that could accommodate electronic transfers, and, as I've said, conventional bank accounts have frequently been too expensive for many households.

In my former role as Under Secretary of the Treasury for Domestic Finance, I had the responsibility for overseeing the EFT '99 project. It quickly became clear to me that unless we could find a way to deliver electronic payments to those millions of families without bank accounts, there would be two very unfortunate consequences. First, we would lose the opportunity to realize significant cost savings for taxpayers. And second, we would lose an opportunity to bring millions of unbanked families into the financial mainstream.

In response to these concerns, we developed the concept of the Electronic Transfer Account, or ETA, which we conceived of as a utilitarian, all-electronic account that would provide payments recipients with the safety, convenience, and efficiency of a low-cost bank account. While we at Treasury designed the specifications for the ETA, after extensive outreach with all interested parties, we left the option to the banks to decide whether to offer the account.

As proposed, ETAs would accept only electronic federal payments; they would be subject to a monthly price ceiling; they would allow at least four free cash withdrawals per month and unlimited point-of-sale transactions; they would require no minimum balance; and would provide a monthly printed statement. The public comment period for the ETA proposal closed in mid-January, and the Treasury Department is now evaluating the comments received. I understand that the Department expects that the final ETA account features will be released later this spring.

The proposed ETA will, I believe, advance the process of bridge-building between banks and previously unbanked recipients of federal payments. It is my hope that all depository institutions will see the benefit of offering ETAs—and one of your important challenges is to bring those benefits to their attention. I urge you to make the ETA an item on your agenda in your discussions with banks about how they can better serve their communities.

But let me emphasize that the ETA should be viewed as an interim measure only—a stepping stone, if you will, to a variety of more full-service banking relationships. It is my hope that as electronic delivery becomes more widely accepted, banks will develop their own low-cost products, adding more and more useful features—and competing to attract the business of those millions of families who need banking services but have remained outside the system.

That will take time. But it will also take more. Information and education are critical to correcting weaknesses in access to traditional payments systems—just as they were critical in our previous efforts in the consumer credit and community reinvestment arenas. The more financial providers actually know about their potential customers in advance, the better able—and more interested—they'll be in tailoring products and practices that will draw people into the system. And educating the currently unbanked about the advantages of dealing with financial institutions—and the responsibilities that come with it—can help overcome the prejudice and misconceptions that have been major barriers to their participation in the past.

This is where NCRC and we at the OCC have important roles to play. For more than a year now, the OCC has been engaged in a comprehensive project to learn more about the financial services needs of those currently outside the banking system, so that we can help develop effective responses. Along with industry groups, we have sponsored forums on barriers to more inclusive banking, and have disseminated guidance on best practices across the financial services industry. And we are in the latter phases of a pioneering empirical study that has surveyed 2,000 people in low- and moderate-income neighborhoods in New York City and Los Angeles County to learn more about the financial activities of the unbanked, the costs they incur, their attitudes toward banks, and any prior experiences with banks. From this survey, we hope to better understand obstacles to participation in the banking system, at least in these two major urban areas. Once these data are fully analyzed, we will report them to the public, hopefully later this year.

NCRC and its network of community organizations have been leaders in grassroots efforts to promote financial literacy—on your own and, for many of you, as part of the Financial Services Education Coalition. It was a recognition of the effectiveness of your community-based approach to financial education that NCRC was selected to lead the EFT '99 public education campaign in the South and Midwest. Educating consumers about the benefits of becoming participants in the financial system—and the rising costs of not participating—is vitally important in achieving our nation's economic and social goals, and, over a long period of time, no one has done it better than those represented here this morning. I commend you for your efforts in this area, to which I know you will continue to apply your customary dedication, sensitivity, and skill.

I began my time with you this morning by evoking our country's spirit at the dawn of this century. Americans of that era conquered their fears—and new frontiers—by forging partnerships to bring the American promise within reach for millions. Today, with the next century almost at hand, we have the chance to advance opportunity still further by advancing the frontiers of access to financial services. Through the same committed partnerships that have brought us success to date, I believe we will enjoy still greater success in the future.

Remarks by Julie L. Williams, Chief Counsel, Office of the Comptroller of the Currency, before the Third Annual Race and Relations Conference, Louisville and Jefferson County Human Relations Commission, on being responsive to the full diversity of financial needs, Louisville, Kentucky, January 28, 1999

It's a pleasure to be here in one of the region's friendliest cities—and, historically, among its most progressive. Louisville has long embraced policies that promote and protect fairness in everything from public accommodations to employment to the sale and rental of housing. This commission—and this conference—reflect your city's leadership in making the goals of social justice and racial harmony a living reality.

The Office of the Comptroller of the Currency, known as the OCC, has also had a longstanding commitment to equal opportunity, in the form of a financial system that is accessible to all Americans. This was a part of the charge we received from Abraham Lincoln when the OCC was created as our nation's first regulatory agency back in 1863. Lincoln, the son of one cash-poor farmer and neighbor of many others in an unbanked community, understood from personal experience that the absence of financial services could be a formidable impediment to economic growth and opportunity. Since his time—and especially in recent decades—we at the OCC have worked hard to fulfill Lincoln's vision of a banking system that meets the financial needs of all of America's citizens, communities, and businesses, small and large.

We need not go back to Lincoln's time to understand the damage that can be done when those needs go unmet. Neighborhoods deprived of financial services and investment are neighborhoods in decline and distress. People who, through no fault of their own, are unable to secure reasonably priced financing to buy a home, start a small business, or pay for higher education, are people whose talents, initiative, and faith may be lost to us forever—a loss potentially as grievous for our society and economy as for the individuals themselves.

That is why the OCC has vigorously reaffirmed its commitment to ensuring that the national banking system *is* responsive to the full diversity of our financial needs. It's not only part of our original mission, but also—as I'll explain later—good business for banks today.

The Community Reinvestment Act is a very important part of this effort. As your program notes, CRA is an increasingly valuable tool for those dedicated to rebuilding America's communities. But that has not always been the case throughout CRA's 20-year history. At the outset and for many years thereafter, bankers and community activists were united by little more than the common conclusion that CRA didn't work. Today these same groups are united, instead, in economic development initiatives that are making a big difference in the lives of our people—projects that have already pumped billions of new private-sector dollars into affordable housing, community development projects, and small businesses. CRA lending and investments have underwritten the expansion of African-American churches in Brooklyn, New York, the renovation of a 100-unit apartment complex in a disadvantaged neighborhood of my hometown of Washington, D.C., the provision of much-needed retail services in the Roxbury section of Boston, and the strengthening of small businesses through the Enterprise Development Center right here in Louisville.

So we can point with pride to the remarkable transformation of CRA from its troubled—and many would say ineffective—past into a more powerful and focused instrument for community renewal and expanded banking markets.

But how do we *explain* this transformation? I would like to think that sensible, responsive regulation has been a factor. In 1993, after evaluating literally thousands of public comments and holding dozens of public hearings, the OCC, along with the other federal banking agencies, implemented a comprehensive reform of the CRA regulations. We went through the CRA rules and tossed out dozens of provisions that simply had generated paperwork and administrative headaches for financial institutions. As a result, funds that would otherwise have been expended on the mechanics of compliance have become available for strengthening communities. When OCC examiners now visit a national bank to conduct a CRA exam, they focus not on the number of meetings it has held or the advertising copy it produces, but on the dollar value of the loans and investments it has actually made in its communities.

The revised regulation itself is still very much a work in progress. We continually reevaluate it in light both of our examination experiences and the public comments we receive. Such flexibility is critical in light of the rapid changes, structural and technological, currently taking place in the banking business—changes that have significant CRA implications. For example, what kinds of new bank products qualify for community development consideration under CRA? And how do we define an institution's assessment area for CRA purposes? This was a relatively simple question when banks conducted all of their business out of brick and mortar offices. But it's not so simple when banks make loans or gather deposits over the Internet, as increasing numbers of them do.

Furthermore, we are keenly aware of the concerns that you and others may have over the trend toward consolidation in the banking business. This trend reached new heights in 1998, with the announcement of one big bank merger after another—mergers that raise many important questions about the future of financial services in our country. What will the impact of so-called mega-mergers be on the communities served by the merging institutions? Will the loss of local ownership lead to a reduction in the local availability of financial services? Will a bank's commitment to the community suffer when its headquarters—and most of its staff—operate somewhere else? And will these giant financial institutions turn a deaf ear to the needs of small borrowers and retail customers and choose to focus their energies on customers of a size comparable to their own?

We will be watching closely to see what results actually come from these mega-mergers. For now, at least, there is some reason for optimism. The consolidation of financial institutions announced in the past year has led to announcements of significant new community lending and investment programs by the merging banks. For example, last year NationsBank and Bank of America announced a plan to make $180 billion in small business loans over a 10-year period.

We are also working with the other banking regulatory agencies to clarify new issues that continue to crop up in connection with CRA implementation. To that end, we will soon publish a revised set of questions and answers on various aspects of CRA—questions gleaned from our own compliance exams, from the institutions we regulate, and from groups and individuals such as yourselves. The issues covered range from the technical to the prosaic—from offering new working definitions of "affordable housing" and "community development" to addressing the question of how examiners are to account for CRA loans when the borrower's address is a post office box. Do renewals and refinancings count toward CRA credit the same as the original loans? What about multiple originations to the same eligible business? And, in recognition of the link between economic opportunities and community development, shouldn't a bank's small business *contracting* program warrant CRA recognition when it is linked to the same bank's small business *lending* program?

The proposed answers to these often technical questions hardly qualify as light reading. But I believe that they provide important insight into the underlying philosophy and the practical complexities of administering CRA today—insight that should be of value to everyone with an interest in the economic redevelopment of America.

Cooperation and understanding. Mutual self-interest and partnerships. Innovation and performance. These are perhaps not the chords you might expect a government regulator to strike. But they *are* the principles and imperatives that I think are most important about how we administer the CRA today and those that are critical if we are to achieve success.

And this, to me, may be the most significant change that has taken place in moving from the old CRA regime to the new. Although we have refined the process of CRA in the ways I have already mentioned, it is the new philosophy behind the regulation that is likely to have the greatest and most lasting positive impact on our communities and our country. It is a philosophy based on our evolving, dynamic, competitive markets and on contributions of the information revolution. In banking and elsewhere throughout our economy, business people are recognizing and capitalizing on opportunities previously blocked by old habits and stereotypes.

It used to be that bankers could afford to stick to the status quo because their traditional business was thriving. But today, bankers have little choice but to be more creative in seeking out new customers and new markets. The financial world has changed. Increasingly, conventional business borrowers tap the capital markets to obtain financing. Bankers face relentless competition for commercial and industrial loans, competition that yields increasing risk and diminishing returns for their traditional lending business. Middle- and upper-income consumers by the millions have abandoned their banks for the products of Wall Street. Foreign-owned banks proliferate on our shores. Of necessity, then, bankers, aided by new information technology, are taking a fresh look at long-slighted markets—which are in fact solid growth markets—for consumer loans, affordable mortgages, small business financing, and community development.

You and your communities need financial services. More than ever before, those whose business it is to provide those services also need you. And they are acting on it. The possibilities for profitable partnerships between America's bankers and our communities have never been more promising.

With this shift in business orientation has come a subtle but meaningful shift in the proper role of government. First, let me assure you that, whatever else we do, we will never stop working to identify and eradicate market irrationalities and injustices, such as discrimination based on race, gender, or other illegal considerations, as long as such practices exist. And today, we see these issues manifested in more complex and subtle forms than outright discriminatory practices. That is why, just last month, we revised our fair lending examination procedures to include new procedures specifically directed to steering, redlining, and discrimination in commercial lending, as well as in the underwriting and pricing of loan products. And, as always, when we are able to substantiate abuses, we will bring them to the attention of the Department of Justice for prosecution.

But the emerging model for bank regulation increasingly involves the removal of obstacles that interfere with the efficient operation of the marketplace. And, increasingly, we are reaching out to serve as facilitators between financial providers and consumers to help both parties bridge longstanding gulfs of misunderstanding, misinformation, and mistrust, to help them to recognize the mutually beneficial relationships that are possible for them.

One area in which we have devoted considerable effort—and, I believe, done considerable good—is in the field of small business lending. Nothing is more crucial to our nation's continued economic vitality and opportunity than the health of its small business sector—the source of innovation and employment for millions of Americans. And there is no place where innovation and employment is more needed than in our disadvantaged communities.

Unfortunately, small business formation has lagged in the very places where we need it most. For example, African-Americans continue to be underrepresented in the business population. And the businesses they do own generate lower revenues and profits and employ fewer people than the average small business. That's because black-owned businesses are underrepresented among the most capital-intensive—and remunerative—segments of the business economy: construction, finance and insurance, wholesaling and manufacturing. One crucial element, then, of our national strategy to improve our neediest communities must be to support initiatives that provide needed credit access and equity for minority small businesses.

The financial regulatory agencies have addressed this need in various ways. For example, we have used CRA to help us collect small business loan origination data, to enable us to track our progress and identify areas requiring special attention. And, in keeping with our new emphasis on outreach and education, more than a year ago the OCC launched a project we call Banking on Minority Business—a project designed to bring bankers and minority small business people together, to help close the communications gap that so long kept them apart, and to develop and exchange ideas that can make small business partnerships work. Hundreds of national bankers, minority small business owners and people who aspire to that status, and business development officials have attended these meetings in cities across the country. Many mutually profitable relationships have been formed as a result.

We look forward to continuing to help break down barriers to mutually beneficial private and public sector partnerships to bring a better future within reach for more Americans. I hope it will be possible to come back to Louisville soon and have one of our banker/community group outreach meetings here.

I began by talking about Abraham Lincoln and the special significance he has for the OCC. The dilemma of race was the central preoccupation of Lincoln's life. As president, he led this nation into a bloody civil war to resolve it. Yet Lincoln understood that true equality could not be achieved through force of arms. He understood that economic opportunity was the key to building a truly color-blind society. That was why he created the national banking system. We at the OCC continue to honor his charge.

Lincoln put us on the path we walk today. We have some distance to go before we achieve his vision—the same vision that inspires your work here in Louisville.

Remarks by Julie L. Williams, Chief Counsel, Office of the Comptroller of the Currency, before the National Association of Affordable Housing Lenders, on financial modernization and the public interest, Washington, D.C., February 9, 1999

I would be delighted to join the National Association of Affordable Housing Lenders under any circumstances, if only to pay tribute to the vitally important work that you do as individuals and as members of this fine organization. Individually and collectively, you are the reason why the 1990s has been a decade of breakthroughs in developing private sector solutions to our nation's critical need for affordable housing. I have watched your work with interest and admiration over the years, and so it's particularly gratifying to have the opportunity to play a small part in your proceedings today. Thank you for inviting me.

Your two-day gathering here in Washington will no doubt hear discussions of promising strategies for addressing our nation's housing deficit. But I think that you'd agree that the real test of what you accomplish here will take place when you return to your homes and communities and places of work and begin putting these ideas into action.

That is true in a general way about much that goes on here in the capital. As a lifelong resident of the Washington, D.C., area and career federal official, of course, you would hardly expect me to contend that what takes place in the halls of our national government is irrelevant to our national life. To the contrary, it matters profoundly. But there is, frankly, an unmistakable tendency in this town, among its permanent and transient residents alike, to view Washington as the hub upon which America, if not the world, turns. Certainly there have been moments in history when that has been the case. For the most part, however, Washington has not been the *source* of the major trends and innovations that shape American life. It responds to those trends and innovations, but rarely creates them. For the true source of our nation's political and economic genius, one must look to the private marketplace, state and local governments, and to the work that *you* do—not to Capitol Hill, nor—dare I say—to the offices of federal bureaucrats.

It is important that we keep this in mind as we consider the future of financial services in this country. During the last session of Congress, considerable attention focused on H.R. 10, the Financial Services Act of 1998, which, as you know, passed the House by a single vote and then stalled in the Senate. Still, this was the closest we have come in years to a comprehensive overhaul of our financial laws.

As I have had an opportunity to reflect back on that legislative effort and to contemplate the financial modernization legislation beginning to percolate in the new Congress, it has struck me that H.R. 10 was premised on a fundamental misconception—the same misconception that, as I have already suggested, is pervasive in Washington. In this specific case, it was the assumption that financial modernization in the United States was dependent upon federal legislation. This starting point then led to massive legislative proposals containing complex and elaborate definitions, redefinitions, and categorizations of financial products, mounted in new frameworks that allocated how and by whom those products could be offered. For the banking industry, and for consumers, communities, and businesses that rely on the role of banks in our economy, this approach has far-reaching consequences.

I would respectfully suggest that, regardless of what Congress does or does not do, financial modernization is taking place all around us, on every Main Street in America, as financial institutions are forced to compete and adapt to rapid social and economic changes. Some of those changes are demographic, as the U.S. population grows older, better educated, and more ethnically diverse. Technology continues to erode physical boundaries, bringing more financial choices than ever before to America's homes and desktops. And new financial products and services are constantly being devised, packaged, and repackaged to respond to these changes in the social and economic landscape.

Understanding this working dynamic between Washington and the financial system is crucial in shaping legislation and in defining an appropriate role for government to play as we prepare for the financial world of the 21st century. Rather than trying to paper over this reality, financial modernization should build on it.

And that leads me to the conclusion that the overriding objective of legislation must be to nurture—and avoid obstructing—the process of financial modernization I have just described—the process by which financial institutions are responding creatively to demographic, technological, and economic trends. Financial providers must be free to market their products and services, and otherwise to organize and conduct their businesses in the way that maximizes their ability to satisfy customers and meet the competitive challenges of the global marketplace. If they cannot do these things, their businesses will suffer, their customers may be disadvantaged, and, ultimately, our whole economy will be weakened.

The goals of financial modernization *legislation,* therefore, should be to enable marketplace modernization to continue in a way that promotes competitiveness and free markets, ensures the safety and soundness of financial institutions, and affords protections to consumers against new risks that may arise from marketplace developments. This could be done, I believe, with relatively straightforward legislation that simply eliminates antiquated and artificial market restrictions and restraints, addresses the customer protection issues that result, preserves the appropriate supervisory roles of *all* financial institution regulators, and allows *all types* of financial institutions to operate their businesses efficiently, safely, and soundly.

Obviously, among these goals, enhancing safety and soundness of insured institutions is a pressing public interest. Banks play a role in our economy unlike any other type of financial institution, and will do so into the foreseeable future. For most Americans, they are the gateway to the payments system. They provide the lion's share of the nation's consumer and small business credit. The taxpaying public ultimately stands behind their deposit liabilities. In return, banks are subject to the most rigorous government scrutiny and highest standards of propriety in the financial services industry.

And they have explicit consumer and community responsibilities under the law that apply to none of their peers—not credit unions, and certainly not finance companies, insurance underwriters, and securities firms. People like yourselves in the affordable housing and community development arenas may find financing from these nonbank financial providers or maybe you won't—it's a matter of chance as opposed to one of regulation and law. The banking industry, by contrast, does not have the option of turning its back on you.

It stands to reason, therefore, that one crucial test of proposed financial modernization legislation should be whether or not it is likely to enhance the safety and soundness and competitiveness of the banking system so that banks can continue to discharge their private responsibilities to shareholders and employees and their public responsibilities to customers and communities. To the extent that legislation does *not* advance these goals—or tilts the balance in favor of nonbank financial organizations that face fewer public obligations—it would not seem to be consistent with the public interest.

Let me give you an example—one that I'm sure you'll appreciate. Fifty years ago, banks essentially did two things. They accepted deposits and made loans, mostly to medium- and large-sized businesses. Because the cost of these funds was capped by regulation and the borrowers had few other options, banks turned predictable profits. But when interest rate ceilings were lifted and the capital markets became more accessible, volatility increasingly overtook the banking business. Bankers were forced to step up the search for customers, and in many cases wound up replacing high-quality loans lost to the capital markets with lesser ones. Indeed, the banking crisis of recent times—especially that of the late 1980s and early 1990s—resulted very largely from excessive concentrations of certain types of loans. It was a lesson that bankers—and regulators—were determined not to forget.

Our recent gains in affordable housing and community development are attributable in part to the health of the banks to which many Americans look for financing. And *that* has been the result not only of a favorable interest rate environment and the general prosperity of our economy. Banks *have* learned their lesson. One reason they are stronger is that their income streams are more diversified. They have reduced their once near-exclusive dependence upon loans, with all of their ups and downs. Thanks in part to their own initiative and to changes in law and regulation that made it possible, bankers can now offer their customers a basket of products and services that yield both interest *and* fee income. Indeed, non-interest income has been rising steadily as a percentage of total operating revenues over the past 15 years, with especially dramatic gains registered over the past five. Banks today derive significant revenues from fees received for selling various types of financial products and such activities as mortgage servicing, securities processing, asset management, foreign currency transactions, and credit card operations. This activity not only produces steadier, *short-term* profits, but solidifies relationships with customers that can mature into profitable *long-term* relationships. And that means new and renewable resources to provide financial services to all Americans and to fund the rehabilitation and redevelopment of America's needy communities.

Obviously, then, legislation that would constrain banks from entering new lines of financial business or prevent them from structuring these activities in a way that strengthens their balance sheets and their relationships with customers has profound consequences. Indeed, as finance increasingly requires the ability to respond flexibly and speedily to attract and satisfy customers, any legislation that hobbles banks by restricting their options, flexibility, and efficiency is effectively a blueprint for undermining their long-term safety and soundness and viability.

Yet last year's H.R. 10 envisaged doing just that. As part of its comprehensive approach to defining, redefining, and categorizing products and allocating how and by whom they could be offered, it would have required a whole range of activities, old and new, to be conducted by holding company affiliates—not banks and not even subsidiaries of banks. The activities in question included a wide and potentially expandable range of insurance activities and such things as loan participations, underwriting certain securities, securitizing loans, acting as a custodian for managed accounts, offering self-directed individual retirement accounts, arranging private placements, engaging in certain financial contracts, and offering employee and shareholder benefit plan services. Under the legislation passed by the House, none of these activities could have been performed directly by banks and many would have been barred for bank subsidiaries as well. And so the income derived from these activities would not have been available to the bank.

Only banks were singled out by H.R. 10 for these types of product restrictions and organizational limitations. The rationale given for this approach has been that the activities in question posed excessive risk to the bank's safety and soundness and, therefore, to the bank insurance fund. This is not the time to enter into a detailed discussion of the particulars of that case. I will simply offer two points for your consideration. One of those I have made already. But it bears repeating: no type of financial provider is subject to more rigorous government scrutiny and higher standards of propriety than banks.

And the second is this. Back in the fall, when H.R. 10 was being debated in the Senate, an extraordinary op-ed piece appeared in the trade newspaper *American Banker.* It was signed by three former chairmen of the Federal Deposit Insurance Corporation: William M. Isaac, L. William Seidman, and Ricki Helfer. These distinguished statesmen and woman went on the record to declare their common conviction that Congress should *not* require expanded activities to be conducted within a bank holding company affiliate. Indeed, they declared the holding company inferior to the bank subsidiary as a safeguard against systemic risk. Current FDIC chair Donna Tanoue also has testified in favor of allowing banks to use their subsidiaries to conduct new financial activities. As the current and former heads of the agency that would pay the price—literally—if they were wrong—their views should carry tremendous weight.

In short, if the H.R. 10 approach to comprehensive redesign of our financial services framework became law, the result would be that banks, *alone* among the financial firms affected by H.R. 10, would be told what financial products they could or could not offer to their customers and how they must organize as a corporate matter to provide these products. In light of the consensus among current and former leaders of the FDIC that this result would *increase* the risk to the federal deposit insurance fund, I think we must reexamine the basic approach to modernization legislation that was embodied in H.R. 10.

Consumers and taxpayers should care very much what approach Congress assumes in developing financial modernization legislation. And so should you. The public and private sector partnerships that have been so instrumental in the rebuilding of our communities depend upon strong banks and a robust banking system. Financial modernization legislation that weakens banks in the long run undercuts what you have been trying to accomplish. But, with a different, more focused approach to legislation, we may have the opportunity to consolidate and build upon the gains of recent years and enhance the ability of America's financial system to provide financial products and services that meet the needs of *all* of our people.

Statement of Michael L. Brosnan, Deputy Comptroller for Risk Evaluation, Office of the Comptroller of the Currency, before the Financial Institutions and Consumer Credit Subcommittee, U.S. House Committee on Banking and Financial Services, on overseeing banks' exposures to hedge funds, Washington, D.C., March 24, 1999

Statement required by 12 USC 250: The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Introduction

Chairwoman Roukema and members of the subcommittee, thank you for the opportunity to appear before you today to comment on the issues associated with the Basel Committee's recent reports on bank interactions with highly leveraged institutions and the guidance recently issued by U.S. bank regulators. My name is Michael Brosnan, and I am the deputy comptroller for Risk Evaluation at the Office of the Comptroller of the Currency (OCC). In that position, I am responsible for both capital markets activities and system-wide risk evaluation. The OCC welcomes the opportunity to discuss how we oversee national banks' exposures to hedge funds, which can arise from direct lending or from trading activities.

The term "hedge fund" generally refers to private investment partnerships that use some form of leverage (either through derivative transactions or direct borrowing) to accomplish their investment objectives. The Basel guidance uses the term "highly leveraged institutions" (HLIs), and defines them as large financial institutions that are subject to very little or no direct regulatory oversight as well as very limited public disclosure requirements, and that take on significant leverage.[1]

While not all hedge funds use significant leverage, many do. Therefore, the term "leveraged fund" is often used interchangeably with the term "hedge fund." Most hedge funds have the unrestricted ability to take short positions. Hedge funds use a greater variety of investment strategies and techniques than regulated funds. Hedge funds can also differ in structure depending on whether they are domiciled in the United States or based outside our geographic boundaries.

My testimony today begins with an overview of national bank interactions with hedge funds, followed by a discussion of the major bank regulatory issues related to their relationships with and exposures to hedge funds. Then I will discuss recently issued supervisory reports and guidance on risk management practices, including new OCC and Federal Reserve guidance as well as the recent Basel Committee reports. I also describe the OCC's supervisory approach to bank relationships with hedge funds and how banks are currently responding to the risk management concerns raised by those hedge fund relationships.

National Bank Interactions with Hedge Funds

National banks provide traditional banking services to hedge funds, most of which, when undertaken prudently, present manageable risks to the bank. Among the services banks provide to their hedge fund customers are loans and credit enhancements; serving as over-the-counter counterparties in derivative transactions; fiduciary activities involving private banking, securities lending, execution, clearance, and settlement of trades; and custodial and cash management services.[2] The majority of national bank activities relating to hedge funds can be grouped into two main categories of bank operations: lending and capital market activities.

National banks' financial exposures to hedge funds arise from loans, trading lines, and direct investments. However, only a small number of national banks have any significant exposure to hedge funds. Our on-site

[1] Most hedge funds are structured as limited partnerships. They are largely exempt from federal securities law and regulation by limiting their securities sales to fewer than 100 participants, all of whom would meet the definition of qualified purchasers—"sophisticated" institutions or individuals—meaning institutions with total investments exceeding $25 million and individuals with investment portfolios of at least $5 million. Similarly, fund advisors are not required to be registered and subject to the Investment Advisors Act. Hedge fund managers can avoid the definition of investment advisor by limiting their client base to fewer than 15 hedge fund "clients." Thus, generally, the limited partners (investors) in such funds are a limited number of wealthy, financially sophisticated parties, who must perform their own due diligence of the hedge fund, since the fund is not subject to standardized disclosure requirements.

[2] In addition, national banks may invest directly in a hedge fund provided that the portfolio of the fund consists exclusively of assets that a national bank may purchase and sell for the bank's own account, and the fund otherwise meets all applicable requirements for ownership by a national bank. See 12 CFR 1.3(h).

examiners report that these exposures, which were relatively small last September, have declined further over the past six months. As of September 30, 1998, eight national banks had exposures from firms that are generally categorized as hedge funds totaling approximately $1.8 billion, net of cash or Treasury collateral. As of February 28, 1999, this exposure has declined to $1.3 billion. Currently, no national bank's exposure exceeds 3.0 percent of its total equity capital.

Major Regulatory Issues Raised

Your letter of invitation asked that we identify the major regulatory issues raised by the Long Term Capital Management, L.P. (LTCM) situation and eventual workout by its creditors. The events that led to LTCM's and other firms' difficulties began in the summer of 1997, when deteriorating economies in Asian, and later in Eastern European and Latin American countries, contributed to significant volatility in global financial markets.This volatility also led to unexpected losses related to lending, investing, and trading activities at some large trading banks. Last fall, in response to the uncertain economic environment along with continued volatility, a global flight to quality led to a sudden decrease in market liquidity and a significant widening in credit spreads. As a result, some hedge funds suffered large losses as strategies previously thought to be relatively safe failed under the changing market conditions.

During these volatile times, a small number of national banks had credit exposures to hedge funds through direct loans and counterparty trading lines. The exposures from these relationships were generally small and well-collateralized. However, at some of these banks, complacency in addition to competitive pressures led to certain credit relationships not being underwritten in a manner consistent with normal credit standards. These credits are examples of slipping underwriting standards that the OCC and the other regulators have warned about over the past two years.

While losses from the broader trading and credit exposures, as well as those from the smaller hedge fund exposures, did not materially affect the reported capital positions at national banks, some institutions did suffer significant losses in market capitalization as their equity prices declined disproportionately relative to other industry groups. Furthermore, the reputation of some banks was damaged as investors and other external constituents had lingering concerns regarding banks' abilities to manage their trading and credit risks. The visible market impact of banks' trading and credit losses, combined with general uncertainty in global markets, focused the attention of bank management and supervisors on hedge funds specifically and trading activities more generally.

Last October, several regulatory agencies, including the OCC, testified before the Congress on the issues raised by the near collapse and the subsequent workout by creditors of one hedge fund, LTCM. In that testimony, the OCC reiterated its longstanding view that derivatives and trading activities require banks to adhere to prudent, effective risk management practices. At that time, our on-site examination teams also reinforced the need for bank management to understand the full extent of their credit and trading exposure to leveraged customers, including hedge funds.

To communicate further our concerns regarding needed improvements to risk managed processes, in January 1999 the OCC issued supplemental guidance regarding the risk management of financial derivatives and trading activities—including counterparty credit risk. We also collaborated with international regulators in drafting the recent documents published by the Basel Committee on Banking Supervision that address lending to highly leveraged institutions, such as hedge funds. Currently, we are working with other domestic regulators through the President's Working Group on Financial Markets on two related studies.

OCC Supervision of Bank Relationships with Hedge Funds

Hedge fund exposures historically have not represented a significant source of credit risk for national banks. Very few national banks directly engage in transactions with hedge funds. Those banks that engage in hedge fund transactions typically know the principals of these firms. Banks usually obtain high-quality marketable securities as collateral to secure direct lending and trading exposures. However, due to the dynamic nature of hedge funds' trading activities and the high leverage they sometimes employ, the magnitude of a bank's credit risk in these exposures can change quickly and dramatically. Our supervision of banks' exposures to hedge funds focuses on how national banks identify, measure, monitor, and control the associated credit, market, liquidity, transaction, and compliance risks.

The OCC maintains experienced examination staff on site at the largest national banks in order to provide continuous supervision over our largest and most complex institutions. These examiners monitor trading activities by reviewing reports on risk exposures, periodically testing control mechanisms, and regularly interacting with bank personnel.

The OCC also recognizes that effective supervision requires a highly trained staff. Analytic models used for risk management of trading activities are often complex. The OCC employs a staff of Ph.D. economists who have the quantitative and theoretical training necessary to evaluate bank risk models, and they regularly participate in trading risk management examinations.

Additionally, the OCC has devoted considerable time and resources to training related to derivatives activities. Our Treasury and Market Risk Division (TMR) has engaged outside consultants to assist us in developing a rigorous training program for practical applications of derivatives trading instruments. An increasing number of our on-site examining personnel have attained professional certifications, such as chartered financial analyst, demonstrating our commitment to developing expertise in financial markets. TMR provides oversight and guidance to our cadre of capital markets examiners, in addition to serving as a clearinghouse for information on national bank trading and derivatives activities, among other capital markets topics. TMR has also developed and maintains a series of screening mechanisms that enable us to target examinations of national bank derivatives activities efficiently.

As requested in your invitation letter, the following sections of my statement discuss the OCC's approach to supervising credit risk management, both direct lending and counterparty, as well as our recently issued OCC guidance and how it enhances prior directives. I also contrast our guidance and recent Basel Committee reports and Federal Reserve guidance on this subject.

Supervision of Direct Lending Activities

The OCC supervises direct credit exposures to hedge funds using the framework described in our "Loan Portfolio Management" booklet (April 1998) in the *Comptroller's Handbook* series. Our examiners review large credit exposures, both funded and unfunded. They also review credit exposures from new or developing product lines or target markets, focusing on areas that have shown rapid growth or high profitability, or that represent vulnerabilities for the bank.

Our examiners assess how bank management identifies, measures, and controls risk throughout the credit process, by reviewing the bank's strategic direction, risk appetite, and risk management process. When OCC examiners evaluate a national bank's loan portfolio and credit risk management practices, including a bank's lending relationship with hedge funds, they review the following components:

- Credit culture and loan policy: Do the bank's policies establish prudent risk tolerance levels and are they consistent with the bank's strategic direction?
- Loan approval process: Does the approval process provide sufficient controls to ensure acceptable credit quality at the time of origination?
- Allowable types of loans: What are the types of lending relationships approved by bank management, and does the bank have sufficient expertise to underwrite and supervise these relationships? This is particularly relevant for hedge funds, whose dynamic trading strategies require that the bank have expertise in a number of credit-related functions.
- Underwriting criteria: Do the credit analysis and due diligence of individual credit exposures support bank management's underlying credit decisions? Evaluation of business strategies and risk management processes is particularly important, given that financial statements provide little information for assessing prospective credit risk.
- Ongoing monitoring procedures: Does the bank conduct satisfactory quantitative and qualitative reviews of the credit relationship with appropriate frequency?
- Documentation exceptions: What are the level, composition, and trend of documentation exceptions?
- Credit risk control function: Do the internal credit administration, loan review, and audit functions ensure the reliability and effectiveness of the bank's risk management process?
- Integrity and quality of the risk rating process: Is the bank's risk rating process analytically sound?

Supervision of Capital Markets Activities

The process of reviewing counterparty credit risk from trading activities is similar to that used to review risks from direct lending activities, but the dynamic nature of trading exposures presents some unique issues. Since bank transactions with hedge funds largely involve derivatives, regulatory guidance and examination activities relating to derivatives transactions are particularly important.

Over the past six years, the OCC has expanded its examination procedures for derivatives and trading activities. In particular, we have developed detailed counterparty credit risk examination procedures that guide our examiners in their analyses of credit exposures that arise from derivatives and trading activities.

On January 25, 1999, the OCC released OCC Bulletin 99–2, "Risk Management of Financial Derivatives and

Bank Trading Activities—Supplemental Guidance (BC 277 Supp. 1)." This bulletin supplements Banking Circular 277, "Risk Management of Financial Derivatives" dated October 27, 1993 and our previous guidance in the *Comptroller's Handbook for National Bank Examiners,* "Risk Management of Financial Derivatives," dated January 1997. OCC Bulletin 99–2 highlights existing shortfalls in the risk management systems of financial institutions and identifies sound risk management practices. This supplemental bulletin provides enhanced guidance for examiners in their reviews of bank trading activities in general, and derivatives more specifically, when evaluating the following issues:

- Counterparty limits: Does the bank set presettlement risk and settlement risk limits with its counterparties commensurate with the bank's risk tolerance and the sophistication of its risk management systems?
- Underwriting: Does the bank know the firm's principals and require appropriate levels of collateral margin; are loss thresholds (i.e., unsecured credit exposure) granted prudently?
- Stress testing: Does the bank have adequate mechanisms for stress testing its credit and market risk profiles to identify the impact of adverse market conditions on cash flows and asset/collateral values?
- Collateral monitoring systems: Collateral is an important risk mitigation tool for hedge fund relationships. Does the bank perform accurate and timely market valuations of counterparty trading positions to determine the sufficiency of collateral coverage? Does the bank have an adequate process for ensuring that it makes collateral calls when necessary?
- Interconnection risks: Has bank management developed reasoned analytical responses to interconnection risk, i.e., the fact that when market risk increases, there may be a concurrent increase in credit, liquidity, compliance, and transaction risks? How does the bank assess the impact of liquidating collateral in unstable markets?
- Risk measurement models: Do the bank's models effectively measure credit and market risk exposures of trading portfolios, and is management cognizant of the limitations of model output?

National Bank Risk Management Response Since October 1998

Through our on-site supervision of national banks' risk management processes, OCC examiners have identified a number of actions taken by banks to improve the management and control of exposures to hedge funds since last fall. Some banks have reduced credit limits and/or eliminated relationships with hedge funds. National banks are, in some cases, obtaining improved risk information from hedge funds, including profit and loss volatility information and more frequent financial statements. National banks have narrowed the types of acceptable collateral, are demanding greater collateral margins, and are reducing unsecured positions. Finally, national banks are exploring how they might make better use of stress testing to determine the vulnerability of their hedge fund exposures to adverse market conditions.

Basel and U.S. Bank Regulatory Guidance

The OCC was a major contributor to the documents published in January 1999 by the Basel Committee on Banking Supervision, "Banks' Interactions with Highly Leveraged Institutions" and "Sound Practices for Banks' Interactions with Highly Leveraged Institutions." The first document presents an evaluation of the potential risks resulting from the activities of highly leveraged institutions (HLIs), with particular regard to their interactions with banks; assesses the deficiencies in banks' risk management practices related to HLIs; and evaluates alternative policy responses for addressing these risks, including the encouragement of sound practices on the part of banks. The second document identifies sound practices for the management of counterparty credit risk inherent in banks' trading and derivatives activities with HLIs. Its recommendations are directed at relationships with HLIs. This paper focuses on the management of credit risk by addressing the establishment of clear policies and procedures for banks' involvement with HLIs as part of their overall credit risk environment; information gathering, due diligence and credit analysis of HLIs; the development of more accurate measures of exposures resulting from trading and derivatives transactions; meaningful overall credit limits for HLIs; linking credit enhancement tools to HLIs; and close monitoring of credit exposures of HLIs.

Guidance issued by the OCC, Basel Committee on Banking Supervision, and the Federal Reserve Board is consistent in how they address the issue of credit risk as it relates to hedge fund counterparties. The only differences are in the scopes of the documents. The OCC document is the broadest, covering credit risk as well as market, compliance, and transaction risk management issues. The OCC's guidance applies to all derivatives and trading activities, regardless of whether or not the bank is engaged in hedge fund related business.

The scope of our guidance was broader than credit risk as we intended to address the risk management deficiencies noted in areas that present much greater financial exposure than those related solely to hedge funds (i.e., emerging market investments and counterparty exposures beyond hedge funds). This guidance was designed to aid examiners in identifying design weaknesses in bank risk management systems and incorporates a full menu of "lessons learned" from various financial services firms over the course of the past 18 months. The Basel Committee's report was intended to be narrowly focused, concentrating specifically on the development of sound counterparty risk management practices for banks with credit exposures to highly leveraged institutions. The guidance issued by the Federal Reserve focuses on counterparty credit risk management—related to all counterparties—not just hedge funds.

The OCC is participating in two efforts led by the President's Working Group on Financial Markets, which is studying the hedge fund and OTC derivatives markets. As Treasury Deputy Assistant Secretary Lee Sachs recently testified, the Working Group has not yet completed its studies and a number of issues are still under consideration.

Beyond the study and sound practices paper issued through the Basel Committee on Banking Supervision, we are not aware of any additional guidance issued by the bank regulatory agencies of other countries.

Conclusion

In conclusion, I want to emphasize three points. First, relatively few national banks have exposures to hedge funds, and those exposures have declined since the problems of LTCM surfaced last year. Nonetheless, those banks that do have exposures are among the largest national banks, and it is critical that they manage that line of business carefully in light of the reputation risks involved. Second, banking necessarily involves risk. What banks and regulators must do is continuously focus on areas of vulnerability. National banks are making good progress to comply with our recent supervisory guidance, but difficult challenges remain in areas such as credit risk stress testing and interconnection risk analysis. Our supervisory efforts will continue to encourage and evaluate progress on these fronts. Third, there is no substitute for on-site, experienced supervisory staff who can observe changes in a bank's risk appetite and exposures, periodically test control mechanisms, and meet directly with bankers to discuss how they are managing their risks.

Statement of James D. Kamihachi, Senior Deputy Comptroller for Economic and Policy Analysis, Office of the Comptroller of the Currency, before the Capital Markets, Securities, and Government-Sponsored Enterprises Subcommittee, U.S. House Committee on Banking and Financial Services, on the impact of technology on the financial services industry and capital markets, Washington, D.C., March 25, 1999

Statement required by 12 USC 250: The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Introduction

Mr. Chairman and members of the subcommittee, the Office of the Comptroller of the Currency (OCC) is pleased to participate in this hearing on the impact of technological advances on the financial services industry and capital markets. The policy implications posed by technology-driven changes in the financial sector deserve careful review, and I commend the chairman for holding this timely hearing.

I am James Kamihachi, senior deputy comptroller for Economic and Policy Analysis. At the OCC, my responsibilities include analyzing how changes in the economy and in the financial services industry affect the regulation and supervision of national banks. In addition, I oversee a division staffed by financial engineers who are experts in understanding the models that banks use to measure and manage their financial risks. In recent years, a portion of our work has involved looking at many emerging retail products that banks have under consideration, including electronic money, bank Internet Web sites, and electronic bill presentment and payment systems. We, along with the Federal Reserve, have been a major participant in international fora helping government policymakers understand and appropriately respond to emerging developments in retail banking and payments technologies.

Information technologies have always shaped the production and delivery of banking services and molded the structure of the industry because information is the essence of banking. Banks were among the first businesses to make wide-scale application of mainframe computers. In recent years, the financial services business and the economy are being transformed in more fundamental ways than before, due to the rapid decline in the price of computers and the persistent increase in computing power over the past 15 to 20 years. Traditional boundaries between different sectors of the financial services industry are blurring, and low-cost communications are making it easy for consumers to comparison shop and for institutions to compete on a global basis; markets and major financial services firms are interconnected world-wide. No one can know with certainty where these changes will lead.

My objective this morning is to share with you some observations about how technology is changing the face of banking and financial services, more generally. I will begin by touching on some important technology-driven developments in banking and payments. Then, I will offer some thoughts on how government can meet its obligations to promote the public interest without erecting barriers to innovation. Finally, I will conclude by discussing how the OCC is responding to the impact of technological changes on banking.

Major Technology Breakthroughs Are Relatively Rare

The sheer volume of existing and emerging financial products and services makes it difficult to gain a clear picture of how technology is changing the market. To sort out the most important changes and trends, I find it helpful to refer to an observation recently made by an industry analyst. He argues that fundamental technological breakthroughs in consumer financial products have been relatively rare; credit cards and ATMs are the primary examples of technology-driven products that have achieved widespread acceptance and have fundamentally altered consumer financial behavior.[1] It is also true that it took a long time for these products to be widely adopted.

Many promising technologies have failed to gain wide acceptance because they did not add enough new value for consumers and businesses to change their behavior. Consider, for example, electronic money. Over the past several years, a number of companies developed e-money products; banks and nonbanks formed ventures to issue, redeem, and otherwise participate in the e-money business; and pilot products received a good

[1] See Marks, James, *Electronic Brokerage: Setting the Pace in Online Financial Services,* Deutsche Bank Research (September 28, 1998), who argues that while there is significant potential for fundamental change in the way we do banking, changing the customs and habits of banking consumers is not easy.

deal of attention from the business and financial press. Thus far, however, e-money as a standalone product has not had wide appeal to potential users, at least in the United States, because it has not been viewed as a good substitute for other means of payment.

On the other hand, online brokerage activity has exploded. Just a few years ago, online trading accounted for a negligible share of retail securities trades; now, approximately a quarter of all retail stock trades are done online. It qualifies as a genuine breakthrough in changing how many people invest. Its success has drawn different types of financial services firms into the business. For example, 11 of the 28 largest national banks offer online brokerage.[2] Five of these house the activity in operating subsidiaries of the bank, while six offer it through a bank holding company affiliate.[3] Banks' online brokerages generally are not as large as some Internet-only brokerages or those offered by some traditional securities industry firms; only one is in the top 10. However, the fact that some banks have them indicates that banks are looking beyond their more long-standing "brick and mortar" securities brokerage activities to newer delivery channels.

The stakes are high for government. While many innovations in financial services will not succeed in the marketplace, the potential for new products and services to have tremendous impact on the economy is great. For example, a recent study estimates that the cost of using electronic payment is about one-third the cost of paper-based transactions.[4] Given that same study's estimate that the cost of a country's payment system may be equivalent to 3 percent of its GDP, a complete shift away from paper could reduce payments transactions costs for the U.S. economy by $160 billion annually.

Thus, public policy that affects the pace of technological advancements in financial services must be carefully drawn. To the extent possible, public policy should be guided by a general reliance on the marketplace, and government should avoid policies that stifle innovation. This is necessary to avoid derailing the emergence and application of breakthrough products. It is the convergence of many incremental innovations that provides the foundation for genuine breakthrough products. Commercial use of the Internet is made possible by developments that took place over many decades, including universal telephone service, creation of a network of geographically dispersed servers, and the invention of powerful low-cost computer chips. Where market failures arise, however, government must act. For example, bank regulators must prevent undue risk-taking to assure a stable banking system.

The stakes are high for banks. There are three basic issues at stake for banks. First, banks must identify risk exposures related to the deployment of new technologies and the financial products they enable. Given the fast pace and potentially large ramifications of technological change, managers must concentrate more intensely on risk management and strategic thinking. Second, the competitive ground in the financial services business is shifting. In order to maintain existing customer relationships and acquire new customers, banks and other firms must establish their brand image in the digital world. Third, technological advancements are likely to result in lower operating costs for banks. A recent industry study estimates that the average cost to the bank of handling a customer transaction via a telephone call center is $0.84, compared with $0.26 via the Internet.[5] Banks are well aware that those institutions that can switch the most customer transactions to the least costly delivery channels will have a significant advantage over the rest of the industry.

Bankers are responding to these market and regulatory pressures. A recent OCC study reports that banks' capital investment in technology grew by 20 percent in 1996, due in part to a 40 percent increase in investment in information management, which includes such things as data warehousing and data mining.[6] More recently, an industry study shows that, last year, the banking industry spent $18.7 billion on

[2] For supervisory purposes, the OCC groups these banks together into its Large Bank program on the basis of the asset size of the bank holding companies owning these banks. For two of these banking companies, the lead (largest) bank is a state-chartered bank.

[3] Both the operating subsidiaries and the holding company subsidiaries comply with Securities and Exchange Commission (SEC) requirements for registering as broker–dealers, and the SEC is the primary regulator of these units. The SEC works cooperatively with the National Association of Securities Dealers and the New York Stock Exchange, depending upon with which organization the broker–dealer unit registers.

[4] Hancock, Diana, and David B. Humphrey, "Payment Transactions, Instruments, and System: A Survey," *Journal of Banking and Finance,* Vol. 21, Nos. 11 and 12 (December 1997).

[5] Franco, Stephen C., and Timothy M. Klein, *1999 Online Banking Report,* Piper Jaffray, p. 23 (February 1999).

[6] See Furst, Karen, William W. Lang, and Daniel E. Nolle, "Technological Innovation in Banking and Payments: Industry Trends and Implications for Banks," *Quarterly Journal*, Office of the Comptroller of the Currency, Vol. 17, No. 3 (September 1998), p. 28. Web address: www.occ.treas.gov/qj/qj.htm. The article is attached to this statement [attachment omitted].

information technology, outpacing both the insurance industry's $17.3 billion and the securities industry's $12 billion on information technology spending.[7]

Technological Innovation is Changing the Nature of the Banking Business

Information technology is transforming bank outputs. Traditional products and services have new features, and the range of new offerings is expanding. Entire new lines of business such as derivatives have been created. Banks are also delivering these products and services in new ways. Bank production functions are changing as well. They produce less in-house and buy more from vendors. Powerful, low-cost computers have enabled banks and other financial services providers to make substantial improvements in the sophistication of the quantitative risk measurement techniques they use to manage their portfolios. All of this is causing the structure and competitiveness of the financial services industry to change.

Key developments: banks' outputs. Banks have always been at the center of the payment system. Now, however, technological advancements make it possible to combine and transmit payments with information related to consumer-to-business and business-to-business transactions in ways that lower transactions costs and offer a high degree of convenience. This integration of payment systems, which previously had been viewed like plumbing—important, but unseen and taken for granted—with other transaction information has resulted in an increasingly visible set of new products, over which many financial and nonfinancial firms are beginning to compete. Three outputs are of particular interest in this vein: banking over the Internet, electronic bill presentment and payment, and financial electronic data interchange.

Banking over the Internet has sparked much comment among consumers, businesses, and government. It is clear the Internet is changing the kinds of products banks offer and the way they deliver them. Customers can apply for loans, receive information about bank products, and in some cases move funds between accounts and pay bills over the Internet. These developments have moved the use of electronic technology out of the back office and into the design and delivery of business-to-business and consumer-to-business banking products.

OCC staff recently completed a comprehensive review of Web banking, and found that very few banks currently offer transactional Internet banking.[8] This study defines "transactional" Internet banking as providing customers the ability to access their accounts and, at a minimum, transfer funds between accounts. As of June 30, 1998, less than 5 percent of all commercial banks—374 commercial banks—had transactional Web sites. Large banks are much more likely to offer transactional banking over the Internet, but the study also finds that some small banks offer this service as well, leading to the conclusion that the fixed costs of offering transactional Internet banking are not prohibitive for small banks. Indeed, a recent report in the banking press indicates that not only is it possible for small banks to provide online banking for their customers, but at least a few small banks have excelled at providing this service.[9]

The OCC study also points out that banks offering transactional Internet banking already have a large potential customer base. As a consequence, it is conceivable that Internet banking could achieve breakthrough status very rapidly. These banks account for approximately 40 percent of all household deposits, and we estimate that this number could grow to 50 percent by the end of this year. Of course, questions remain about whether and when banks will develop this product into one sufficiently superior to traditional delivery channels to win broad customer acceptance.

In a basic sense, payment transactions are information transfers that credit and debit accounts. However, most transactions involve additional information exchanges accompanying the credit and debit instructions. Today, electronic payment instructions are typically accompanied by additional transfers of information that are completed through traditional, and relatively costly, paper-based means. For example, most companies must mail paper bills to customers even if the customer pays the bill electronically. A part-electronic, part-paper system may be only a marginal improvement in efficiency relative to an all-paper environment. But, end-to-end "electronification" of consumer-to-business and business-to-business transactions can yield tremendous additional benefits.

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[7] *Bank Technology News,* Vol. 12, No. 3 (March 1999), p. 3, reporting on a Meridien Research/American Banker study. Note that these figures are not adjusted for year-2000 expenditures.

[8] Egland, Kori L., Karen Furst, Daniel E. Nolle, and Douglas Robertson, "Banking over the Internet," *Quarterly Journal,* Office of the Comptroller of the Currency, Vol. 17, No. 4, pp. 25–30 (December 1998). Web address: www.occ.treas.gov/qj/qj.htm. The article is attached to this statement [attachment omitted]. The database for this study included all FDIC-insured banks and thrifts with Web sites, except the handful of "Internet-only" banks and thrifts. We did not include PC banking activities conducted over a bank's own dial-up (i.e., non-Internet, proprietary) system.

[9] See Senior, Adriana, "Small Banks Now Ranked in Web Banking Big Leagues," *American Banker,* Vol. 164, p. 11 (March 18, 1999).

Electronic bill presentment and payment ("EBPP") is a new development that may become a breakthrough consumer-to-business product. Currently, some banks and nonbanks offer electronic bill payment services to customers. Though relatively new for consumers, and not yet widely used, the use of electronic bill payment more than doubled in 1997 compared to 1996.[10] Electronic bill presentment, which is just beginning to emerge as a practical reality, eliminates paper from the beginning of the process. As use becomes more widespread, more businesses may gear up to receive electronic payments, squeezing additional paper out of the last link in the process. Taken together, electronic bill payment and presentment would provide an end-to-end electronification of consumer-to-business payments.

For business-to-business electronification of transactions, financial electronic data interchange (EDI) is a fully operational reality, and has begun to take off, doubling between 1995 and 1997, and growing an additional 43 percent in 1998.[11] Financial EDI is the process of bundling together payments and related information on sales, inventory, and production information. This process allows businesses to reduce operating costs substantially.

Key developments: banks' production functions. Advancements in information technology have changed the way banks can most efficiently produce services. One major change in bank production functions is the degree to which they are turning to outside service providers, rather than attempting to handle all of their production processes in-house. The growing sophistication of new products and services, and the growing complexity of new delivery channels, may make outsourcing not only a more efficient choice, but for many banks, especially smaller ones, the only realistic choice. In addition, banks of all sizes are finding it increasingly difficult to hire and retain the kinds of expertise needed to produce and deliver new products and services.

Increased reliance on financial engineering represents another change in bank production functions. Advancements in information technology allow financial institutions to develop and use sophisticated mathematical and statistical models to more precisely assess, price, and manage risks.

Key developments: banking industry structure and competitiveness. Banking industry structure and competitiveness are affected greatly by advancements in information technology. Two examples serve to illustrate this point. Consider the ongoing consolidation of the banking industry. In the last 10 years, the number of commercial banks decreased by over 4,000 institutions, largely due to mergers. Roll-ups of subsidiary banks by bank holding companies into fewer and fewer separate charters accounted for approximately half of all mergers. To the extent it is important to centralize transactional information, technological advancements give added impetus to the drive by bank holding companies to reduce the number of separately chartered bank subsidiaries.

Technological innovations are also opening the door for nonbanking firms to get into the core business of banking as never before. For example, some online brokers are planning to offer electronic bill payment and bill presentment services to their customers. Nonfinancial firms are increasingly entering the small business loan market by using credit scoring models to process loan applications. Whether nonbank firms will elect to compete with banks or partner with them in offering electronic banking and payments products remains to be seen.

OCC's Supervision Is Adapting to Technological Innovations in Banking and Payments

Emerging technology provides tremendous opportunities for improving the efficiency and quality of financial services. If we are to achieve these benefits, government must refrain from unnecessarily interfering with the market forces propelling technological innovation forward. The OCC has worked domestically and internationally towards this end, and to focus the attention of bank regulators on areas where markets may fail to address the concerns raised by emerging retail banking and payments technologies. These include taking steps to ensure financial integrity, to protect consumers, and to deter financial crimes.

In the current environment of rapidly changing technology, financial integrity rests fundamentally on identifying and managing risks. There are several important categories of risks facing banks and other financial institutions: (1) financial risks, including credit, price, foreign exchange, and interest rate risk; (2) transactional risks, such as security and operational problems; (3) strategic risk, for example understanding how technology fits into the institutions' business plan; and (4) legal and reputational risk, including an understanding of how other risks may have legal and reputational consequences for the institution.

Fundamental consumer protection issues include making adequate disclosures about how new systems and products work, so that consumers can make informed choices about the relative merits of different products;

[10] Furst, Lang, and Nolle, *op. cit.,* p. 27.

[11] Furst, Lang, and Nolle, *op. cit.;* and National Automated Clearing House Association (NACHA) *News Release* (February 1, 1999).

making clear statements for consumers about their rights and obligations with respect to new products and delivery channels; and addressing customer concerns about privacy. Deterring financial crimes rests on designing products with adequate safeguards against criminals, and educating company employees, contractors, and customers about proper precautions.

The OCC has issued guidance for banks and for examiners on risk management procedures for new technologies. For example, our broad guidance on technology risk management, and on PC banking, cover the major categories of risk on which banks should focus. We have also published guidance tailored to particular technology products or issues, including electronic stored-value, credit-scoring, and threats to the information system infrastructure of banks.

The OCC is also working diligently to adapt its supervision to changes in the banking industry. We are undertaking a review of our bank information system (BIS) examination program to ensure that OCC supervision is keeping pace with bank use of technology, and the increasing reliance on vendors and service providers. The widespread use of vendors and service providers in the banking industry means that, in order to evaluate a bank's exposure to transactional failures, we must understand the condition and operation of both the bank and its servicer.

We are also making sure we have the skills we need to understand the increasingly sophisticated technologies banks use. For instance, the OCC is improving the training our BIS examiners receive, and is increasing the number of our examiners who have received industry-recognized certification. Currently, more than two-thirds of our BIS experts are certified information systems analysts. In the area of financial engineering, the OCC is doubling the number of staff who can evaluate the models banks use. When fully staffed later this year, the division within the Economics Department that provides that support to our examination teams will have 20 Ph.D. economists—two for every three of our largest banks.

Conclusion

Advancements in information technology are crucial to the continued vitality of the banking industry. As bank regulators, we must avoid unnecessarily distorting or hindering such advancements. At the same time, we must fulfill our responsibility to see that the integrity of the financial system is not compromised, that consumers are adequately protected, and that criminal activities are prevented. We are working hard to ensure that we understand new developments in financial markets, that we maintain the expertise needed to oversee new products and applications, and that we supervise national banks to make sure they are appropriately managing the risks growing out of applying new technology to banking.

Attachments

[Attachments referenced in notes 6 and 8 are omitted. These are the Special Studies articles previously published in the *Quarterly Journal,* Vol. 17, Nos. 3 and 4, and also available on the Internet at http://www.occ.treas.gov/qj/qj.htm.]

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Interpretive Letters

850—January 27, 1999

12 USC 92(A)
12 USC 24(7)

Re: Proposed Investment Advisory Program

Dear [ ]:

This is in response to your letter requesting confirmation that national banks may enter into arrangements with a registered investment adviser for the provision of investment advice to bank customers. Based on the representations in your letter and for the reasons discussed below, we believe that a national bank may, in the manner described, enter into contracts with an investment adviser to provide services to bank customers.

I. Proposal

[ ] is an investment advisor registered with the Securities and Exchange Commission (SEC) under the Investment Advisers Act of 1940. [ ] intends to enter into contracts with national banks by which banks would, for a fee, refer bank customers to [ ]. [ ] also proposes to enter into contracts with banks to act as a subadviser in providing investment management services to fiduciary accounts at those banks. For the reasons described below, based on the facts and representations provided, we conclude that national banks have the authority to enter into the proposed arrangements with [ ].[1]

[ ] proposes to offer to banks (including national banks) two arrangements ("referral" and "private-label") to generate fee income and to provide investment advisory services to bank customers.

A. "Referral" Arrangement

Under the referral arrangement, in exchange for a finder's fee, a bank would agree to refer bank customers to [ ] for investment advisory services. [ ] personnel would not be present on bank premises and [ ] marketing materials would disclose clearly that customer accounts at [ ] are investments made by [ ] and are not deposits, or obligations of, or guaranteed by, the referring bank; are not insured by the FDIC; and may involve investment risks, including possible loss of principal.[2]

[ ] would provide investment management services in its own name, directly to and under contract with bank customers. While the relationship between the referring bank and [ ] would be disclosed, the bank's role would merely be facilitative, it would not act as an investment advisor or retain investment discretion over customer assets. National banks entering into this "referral" arrangement would not act in a fiduciary capacity and, accordingly, would not generally have fiduciary powers. Referring banks would not negotiate with customers, act as co-advisors, enter into partnerships or joint ventures with [ ] or otherwise have any control over [ ] or the services [ ] provides.

[ ] expects some banks will want to serve merely as finders and will refer customers to [ ] with little or no further involvement in the future relationship between the bank customer and [ ]. These banks will receive fee income from [ ] for the referral without devoting significant resources to support their customers' relationships with [ ]. [ ] anticipates other banks may want to maintain more active involvement in supporting and monitoring their customers' investment advisory arrangements with [ ]. Not only would these banks refer customers to [ ] for a fee, they would also provide ongoing customer-related administrative, recordkeeping, and other non-advisory services on behalf of [ ] for those bank customers who enter into investment management arrangements with [ ]. These banks would receive additional fees based upon the nature and extent of the bank's services.[3]

Depending on how a bank structures its program, [ ] anticipates it may: (1) assist in educating bank personnel about the [ ] program; (2) conduct sales seminars that would be held by the bank; and (3) provide brochures, other marketing materials and forms, including account applications, profiling questionnaires, clearing/custodial/agency applications, and disclosure forms. In addition, although [ ] anticipates it may provide some banks with sample Investor Quarterly Performance Reports, Client Strategy Reports, sample portfolios, investment commentaries, fund analyses, investment policies and other program related documents for the bank's use in introducing customers to [ ], these banks will merely be a conduit for distributing these

[1] The OCC does not endorse particular investment products or investment advisors, and this letter is neither an endorsement nor a criticism of [ ] or any other investment advisor entering into arrangements with national banks.

[2] [ ] and/or the bank would provide these disclosures during sales presentations and prior to or at the time an account is opened. [ ] and/or the bank would obtain a signed customer acknowledgment that the customer has received and understands these disclosures.

[3] [ ] represents these fees would never exceed reasonable and customary fees for such services.

materials and will not act as a co-advisor with [ ] or provide investment advice.[4]

B. "Private Label" Arrangement

The "private-label" arrangement is designed for banks with fiduciary powers that intend to use [ ] as a sub-advisor. Bank customers would enter into traditional investment management agreements with their bank and [ ] would then manage these accounts under a separate sub-advisor agreement with the bank.

II. Analysis

A. "Referral" Arrangement

1. Authority of a National Bank to Act as a "Finder"

The OCC has long recognized the finder function as a permissible banking activity that includes, "without limitation, identifying potential parties, making inquiries as to interest, introducing or arranging meetings of interested parties, and otherwise bringing parties together for a transaction that the parties themselves negotiate and consummate." 12 CFR 7.1002(b). Such activities are part of the business of banking.[5] The OCC has also long recognized that the payment of a reasonable finder's or referral fee in connection with the marketing of trust services, that is disclosed to bank customers, is appropriate.[6] "Unless otherwise prohibited, a national bank may advertise the availability of, and accept a fee for, the [finder] services provided . . ." 12 CFR 7.1002(c).

The proposed "referral" activity for national banks that you describe involves customer referrals, the distribution of materials pertaining to the [ ] program, and related administrative services performed by some banks. National banks may receive finder fees for providing these referrals and services.

2. Authority of a National Bank Without Fiduciary Powers to Enter into a Referral Arrangement with a Third Party for the Provision of Investment Advice to Bank Customers

You have specifically requested that the OCC confirm your view that a national bank without fiduciary powers could permissibly enter into the referral arrangement. Under the proposed "referral" arrangement, a national bank need not obtain fiduciary powers from the OCC in order to refer customers, for a fee, to [ ]. Fiduciary activities that require a national bank to obtain fiduciary powers from the OCC include acting as an " . . . investment advisor, if the bank receives a fee for its investment advice; any capacity in which the bank possesses investment discretion on behalf of another; or any other similar capacity that the OCC authorizes pursuant to 12 USC 92a." 12 CFR 9.2(e).[7] Although [ ] intends that those banks with which it enters into contracts will retain involvement with their customers, those banks will not provide investment advice or retain investment discretion over those customer assets referred to [ ].[8]

Referring banks may engage in a broad range of activities in support of [ ]'s investment advisory activities. For example, a bank may elect only to facilitate account openings before forwarding them to [ ] by reviewing customer account applications and related documents to be sure they have been completed properly. Other referring banks, however, consistent with IL 607, may elect to perform additional customer-related administrative functions such as transmitting documents and acquiring customers' signatures, coordinating sales calls by [ ] personnel, including arranging appointments for [ ] officials who will meet with prospective customers referred by the bank, marketing [ ] products by distributing brochures and holding seminars to be conducted by [ ] personnel, performing market research such as determining the number of prospects in the bank's market area that meet [ ]'s criteria, and identifying prospective customers through other means. As noted in IL 607, finders referring potential trust business are authorized to perform essentially clerical and routine tasks, provided that the finder merely handles and does not generate or produce trust documents or give advice on the meaning or impact of these documents.

While the nature and extent of a bank's continuing involvement would ultimately depend on the bank's business objectives, in all cases where a bank does not possess

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[4] A national bank that exercises fiduciary powers must first obtain approval from the OCC under 12 CFR 5.26 and 9.3.

[5] *See e.g.*, OCC Interpretive Letter No. 824 (February 27, 1998), *reprinted in* [1997–1998 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–273; OCC Corporate Decision No. 97–60 (July 1, 1997).

[6] *See*, OCC Interpretive Letter No. 607 (August 24, 1992), [1992–1993 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,445 (IL 607); Trust Interpretive Letter No. 249 (May 23, 1990) [1990–1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,210; OCC Interpretive Letter No. 504 (May 18, 1990) [1990–1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,202; Trust Interpretive Letter No. 78 (March 4, 1987).

[7] *See also*, OCC Interpretive Letter No. 769 (January 28, 1997), *reprinted in* [1996–1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–133 (clarification of the term "investment advisor" as used in 12 CFR Part 9).

[8] Investment discretion is defined to mean, with respect to an account, "the sole or shared authority (whether or not that authority is exercised) to determine what securities or other assets to purchase or sell on behalf of the account. A bank that delegates its authority over investments and a bank that receives delegated authority over investments are both deemed to have investment discretion." 12 CFR 9.2(i).

fiduciary powers, the bank would be unable to provide investment advice or maintain investment discretion for its customers.

B. "Private Label" Arrangement

The "private-label" arrangement proposed by [ ] is lawful for banks with fiduciary powers. Bank customers would enter into traditional investment management agreements with their bank and [ ] would then manage these accounts under a separate sub-advisor agreement with the bank. Customers would have no direct or contractual relationship with [ ] and all written materials would identify the investment management program as offered by the bank. [ ] may be described in the written materials distributed by the bank as the sub-advisor of the account. This arrangement is consistent with 12 CFR 9.4(c) which authorizes a national bank to "purchase services related to the exercise of fiduciary powers from another bank or other entity." OCC precedent adopted prior to the addition of section 9.4(c) in 1996 expressly recognized that a national bank may find it desirable or expedient to contract for fiduciary support services. Among the services the OCC has recognized in the area of fiduciary support is responsibility for providing investment advice. Fiduciary Precedent 9.1390 *(Comptroller's Handbook for Fiduciary Activities).*[9]

C. Compliance with the Interagency Statement

The Interagency Statement on Retail Sales of Nondeposit Investment Products (February 15, 1994), *7* Fed. Banking L. Rep. (CCH) ¶ 70–101, (Interagency Statement) provides guidance to the industry for avoiding customer confusion where nondeposit investment products are recommended or sold to retail customers of a financial institution. The Interagency Statement applies when retail recommendations or sales of nondeposit investment products are made by: bank employees; third party employees on bank premises; or sales resulting from a referral of retail customers by a bank to a third party, when the bank receives a benefit for the referral. The Interagency Statement would apply to the "referral" arrangement because the bank receives compensation for the referral.

Because the Interagency Statement generally does not apply to sales to fiduciary accounts, the "private-label" arrangement you described in which the bank acts as a fiduciary does not appear to be covered by the Interagency Statement.

[9] *See also*, Fiduciary Precedent 9.1300 (Comptroller's Handbook for Fiduciary Activities) (national bank with trust powers may either perform or purchase trust services for or from a bank or service corporation through a trust services agency agreement); and Trust Interpretive Letter No. 168 [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 84,935 (August 3, 1988) (use of an affiliate to perform trust administrative and investment services).

National banks participating in referral programs such as [ ]'s must comply with all applicable OCC guidance, and operate the program in a safe and sound manner.

If you have any questions regarding this matter, please contact me at (202) 874–4447, or Joel Miller, Senior Attorney, Securities and Corporate Practices Division at (202) 874–5210.

Lisa Lintecum
Director, Asset Management

851—December 8, 1998

12 USC 24(7)

Dear [ ]:

This is in response to your letter dated October 30, 1998 to Eric Thompson, Director, Bank Activities and Structure Division, on behalf of [ ] (FNB or "the bank"), *[City, State].* You requested confirmation that it would be lawful for the bank to hold a noncontrolling minority interest in a new limited liability company that is being established to engage in investment advisory activities. For the reasons set forth below, it is our opinion that this transaction is legally permissible as described herein.

Background

According to your letter, FNB conducts trust and investment advisory activities directly and through its operating subsidiaries under the authority of its charter and 12 USC 92a. In 1995, FNB acquired a controlling interest in an investment advisory firm, the *[T],* and has since held *[T]* as an operating subsidiary. To further the bank's overall investment advisory strategy, the bank seeks to sell a portion of the assets of *[T]* to a newly created limited liability company, the [ ] ("G" or "the LLC"). FNB will own 25 percent of the LLC for a period not to exceed five years. The remaining 75 percent will be held by two of the principals from whom FNB originally purchased *[T], [3]* and *[2].*[1]

[1] *[3]* is the President and CEO of *[T]*. *[2]* is President, Director and CEO of *[AB],* and Chairman of the Board of *[T]*. Concurrent with the sale of the *[T]* accounts to the LLC, both *[3]* and *[2]* will resign from their current positions within FNB and *[AB]* except that *[2]* will continue to serve indefinitely as a director of *[AB].* Since *[2]* is a director of an affiliate of FNB, the restrictions in Regulation O, 12 CFR Part 215, apply to extensions of credit made by FNB to *[2]* or to the LLC, a related interest of *[2],* unless FNB has excluded *[2]* by board resolution. However, the proposed transaction is not an extension of credit for the purposes of Regulation O.

[G] is a SEC registered investment adviser organized under Rhode Island law. You have represented that FNB will sell to *[G]* approximately $367 million of the assets under management, representing approximately one half of *[T]'s* total investment advisory account relationships. *[T]* will continue to exist as a separate entity for some period of time after the transaction to ensure a smooth transition for clients. Those account relationships not sold to *[G]* will be transferred to FNB or an existing operating subsidiary, [ ]. FNB will continue to receive a portion of the investment advisory revenue for certain accounts transferred for a two-year period.

Under the terms of the proposed sale transaction, equity ownership of the LLC will be shared by the bank and the purchasers. *[3]* and *[2]* will jointly own a 75 percent controlling interest in the LLC, *i.e.,* each will own a 37.50 percent membership interest. FNB will receive a 25 percent noncontrolling interest in the LLC. However, FNB will be contractually obligated to sell its equity interest in the LLC to Messrs. *[3]* and *[2]* between one year and five years after the initial transfer to *[G]* is consummated. The timing of the sale will be at FNB's option, and the sale price will be determined at the time of the sale. *[3]* and *[2]* will resign from their current positions within FNB and *[AB]. [2]* will serve as a consultant to *[AB]* under a one-year contract in order to aid in the transition of that company to a new management team and will continue to serve as a director of *[AB]* indefinitely. *[3]* and *[2]* will also provide assistance to FNB during the transition of the advisory accounts from *[T]* to the bank. FNB will continue to provide custody services and certain ancillary systems and data processing support to the LLC.[2] All such services will be provided on terms and under circumstances that are consistent with comparable market practices.

Analysis

The bank's proposal to hold a 25 percent interest in the LLC raises the issue of the authority of a national bank to make a noncontrolling, minority investment in a limited liability company. In a variety of circumstances the OCC has permitted national banks to own, either directly or indirectly through an operating subsidiary, a noncontrolling interest in an enterprise. The enterprise might be a limited partnership, a corporation, or a limited liability company.[3] In various interpretive letters, the OCC has concluded that national banks are legally permitted to make a noncontrolling investment in a limited liability company, provided four criteria or standards are met.[4] These standards, which have been distilled from our previous decisions in the area of permissible noncontrolling investments for national banks and their subsidiaries, are:

(1) The activities of the entity or enterprise in which the investment is made must be limited to activities that are part of, or incidental to, the business of banking;

(2) The bank must be able to prevent the entity or enterprise from engaging in activities that do not meet the foregoing standard or be able to withdraw its investment;

(3) The bank's loss exposure must be limited, as a legal and accounting matter, and the bank must not have open-ended liability for the obligations of the enterprise; and

(4) The investment must be convenient or useful to the bank in carrying out its business and not a mere passive investment unrelated to *that bank's* banking business.

Each of these factors is discussed below and applied to your proposal.

1. The activities of the entity or enterprise in which the investment is made must be limited to activities that are part of, or incidental to, the business of banking.

Our precedents on noncontrolling stock ownership have recognized that the enterprise in which the bank takes an equity interest must confine its activities to those that are part of, or incidental to, the business of banking.[5] The LLC

[2] FNB customer information will remain confidential. As a subsidiary of FNB, *[T]* has no access to any of the bank's information management systems for deposit account or bank customer account information. *[T]* has access only to account information for the management accounts it manages. While FNB will continue to provide certain administrative and data processing services, the LLC will have no further access to the bank's information management systems. No accounts will be transferred to the LLC or FNB without first providing notice and obtaining proper consent of the account holders.

[3] *See also* 12 CFR 5.36(b). National banks are permitted to make various types of equity investments pursuant to 12 USC 24(Seventh) and other statutes.

[4] *See e.g.,* OCC Interpretive Letter No. 778 (March 20, 1997), *reprinted in* [1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–205 and OCC Interpretive Letter No. 692 (November 1, 1995), *reprinted in* [1995–1996 Transfer Binder] Fed. Banking L. Rep (CCH) ¶ 81,007.

[5] *See e.g.,* OCC Interpretive Letter No. 380 (December 29, 1986), *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,604 n.8 (since a national bank can provide options clearing services to customers, it can purchase stock in a corporation providing options clearing services; OCC Interpretive Letter No. 694 (December 13, 1995), *reprinted in* [1995–1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 91–009 (national bank permitted to take noncontrolling minority interest in a limited liability company that purchases secured home improvement loans and resells them in the secondary market); OCC Interpretive Letter No. 711, *reprinted in* [1995–1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–026 (February 23, 1996) (national bank may take a minority equity interest in a mortgage banking company).

will provide investment advisory services and continue to engage in the same investment advisory activities that are presently conducted by *[T]* as a subsidiary of the bank under 12 USC 24(Seventh) and 12 USC 92a. Clearly the activities of the LLC are within the scope of activities which the OCC has previously determined to be permissible for national banks and their operating subsidiaries.[6] The fact that the bank seeks to retain a minority interest in the LLC after the sale of a portion of *[T]'s* assets, does not alter the conclusion that the transaction is permissible. Therefore, this standard is satisfied.[7]

2. The bank must be able to prevent the enterprise from engaging in activities that do not meet the foregoing standard, or be able to withdraw its investment.

This is an obvious corollary to the first standard. The activities of the enterprise in which a national bank may invest must be part of, or incidental to, the business of banking not only at the time the bank first acquires its ownership, but for as long as the bank has an ownership interest.

Your letter states that as long as FNB maintains an interest in the LLC, its Operating Agreement will prohibit the LLC from engaging in any activity that is not part of, or incidental to, to the business of banking under the interpretations of the OCC. You have also stated that the Operating Agreement will provide that this restriction may only be amended by a majority of the interests in the LLC, including those held by FNB and its assigns.[8] Therefore, this standard is met.

3. The bank's loss exposure must be limited, as a legal and accounting matter, and the bank must not have open-ended liability for the obligations of the enterprise.

a. Loss exposure from a legal standpoint

A primary concern of the OCC is that national banks not be subjected to undue risk. Where an investing bank will not control the operations of the entity in which the bank holds an interest, it is important that a national bank's investment not expose it to unlimited liability. As a legal matter, investors in a Rhode Island limited liability company will not incur liability with respect to the liabilities or obligations of the limited liability company solely by reason of being a member or manager of the limited liability company.[9]

Article II, section 2.8 of the proposed Draft Operating Agreement of the LLC provides that "[n]o member or Manager in its capacity as such shall be liable for the debts, obligations or liabilities of the Company, including without limitation under a judgment, decree or order of a court." Additionally, Article II, section 2.10 provides that "[n]o member of the Company shall be subject in such capacity to any personal liability whatsoever to any Person in connection with the assets, acts, obligations or affairs of the Company." Thus, the bank's loss exposure for the liabilities of the LLC will be limited.

b. Loss exposure from an accounting standpoint

In assessing a bank's loss exposure as an accounting matter, the OCC has previously noted that the appropriate accounting treatment for a bank's 20–50 percent ownership share of investment in a limited liability company is to report it as an unconsolidated entity under the equity method of accounting. Under this method, unless the bank has guaranteed any of the liabilities of the entity or has other financial obligations to the entity, losses are generally limited to the amount of the investment, including loans and other advances shown on the investor's books.[10]

As proposed, the bank will have a 25 percent membership interest in the LLC. Your letter states that FNB intends that its proposed investment in the LLC will not be consolidated on FNB's balance sheet under generally accepted accounting principles. Thus, except to the extent that FNB may extend credit to the LLC, the bank's

[6] *See, e.g.,* OCC Interpretive Letter No. 647 (April 15, 1994), *reprinted in* [1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,558 (national banks may establish subsidiaries to acquire assets of investment companies and their subsidiaries, may engage in investment advisory, brokerage and administrative services to various clients, including a family of mutual funds but would not act as distributor of the mutual funds).

[7] We have previously held it lawful for a bank to acquire and hold a minority equity interest in a company which would be the successor to the bank's existing mortgage banking operation. *See* OCC Interpretive Letter No. 711 (February 23, 1996), *reprinted in* [1995–1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,026 (national bank permitted to sell all of the shares of its mortgage company to a newly organized corporation; in return, the bank to receive approximately 45 percent of the voting stock of the new corporation).

[8] Several provisions of the Draft Operating Agreement submitted to us at our request confirm your representations that this standard is satisfied. Section 2.7 of the Draft Operating Agreement provides that the Company must obtain the "written consent of the [ ] prior to engaging in activities other than those expressly permitted in Section 2.5.1. . . ." Section 2.5.1 provides that "while the [ ] is a Member the Company shall engage solely in activities that are part of, or incidental to, the business of banking, as determined from time to time by the Office of the Comptroller of the Currency." Article II, sections 2.7 and 2.5.1, Draft Operating Agreement.

[9] *See* R.I. Gen. Laws § 7–16–23 (1998).

[10] *See generally* Accounting Principles Board, Op.18 § 18(1971) (equity method of accounting for investments in common stock).

risk of loss will be limited to its investment in the LLC as shown on its books.[11] Consequently, the bank will not have open-ended liability for the obligations of the LLC. Therefore, the third standard is satisfied.

4. The investment must be convenient and useful to the bank in carrying out its business and not a mere passive investment unrelated to that bank's banking business.

A national bank's investment in an enterprise or entity that is not an operating subsidiary of the bank must also satisfy the requirement that the investment have a beneficial connection to that bank's banking business, *i.e.,* it must be convenient or useful to the investing bank's business activities and not constitute a mere passive investment unrelated to the bank's banking business. Twelve USC 24(Seventh) gives national banks incidental powers that are "necessary" to carry on the business of banking. "Necessary" has been judicially construed to mean "convenient or useful."[12] Therefore, a consistent concept running through our precedents concerning stock ownership is that it must be convenient or useful to the bank in conducting that bank's banking business. The investment must benefit or facilitate that business and cannot be a mere passive or speculative investment.[13]

The bank, through *[T],* is currently actively involved in providing investment advisory services of the same or similar type as the LLC will provide. FNB's investment in the LLC will enhance its market penetration and earnings in the investment advisory services business and further its overall investment strategy and provide continued services to the bank's customers. Therefore, the proposed transaction will be both convenient and useful to the bank in carrying out its banking business and is not a mere passive investment. Thus, the fourth standard is satisfied.

[11] OCC's chief accountant has concluded that the bank's investment in the LLC should be recorded as "investments in unconsolidated subsidiaries and associated companies" on the bank's Consolidated Reports of Condition and Income ("call reports"). Such classification is consistent with the Call Report Instructions. *See* Instructions to Schedule RC–M, item 8.b.

[12] *Arnold Tours Inc.* v. *Camp*, 472 F.2d 427, 432 (1st Cir. 1972).

[13] *See e.g.,* OCC Interpretive Letter No. 543, *reprinted in* [1990–1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,225 (February 13, 1991) (national bank authorized to acquire nominal stockholding for membership in corporation of primary dealers in government securities); OCC Interpretive Letter No. 427, *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,651 (May 9, 1988) (national bank permitted to buy Farmer Mac stock in nominal amounts); OCC Interpretive Letter No. 421, *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,645 (March 14, 1988) (national bank permitted to invest in the Government Securities Clearing Corporation.

Conclusion

Based upon the information and representations you have provided, and for the reasons discussed above, we conclude that *[Bank, City, State],* may acquire and hold a noncontrolling 25 percent interest in the *[LLC].*

Our conclusion is conditioned upon compliance with the commitments made in your letter of inquiry and with the conditions listed below:

(1) [ ] ("the LLC") may engage only in activities that are part of, or incidental to, the business of banking;

(2) The bank will have veto power over any activities and major decisions of the LLC that are inconsistent with condition number one or the bank will withdraw its investment from the LLC if it proposes to engage in any activity that is inconsistent with condition number one;

(3) The bank will account for its investment in the LLC as an unconsolidated entity under the equity or cost method of accounting; and

(4) The LLC will be subject to OCC supervision, regulation, and examination.

These commitments and conditions are conditions imposed in writing by the OCC in connection with its action on the request for a legal opinion confirming that the proposed investment is permissible under 12 USC 24(Seventh) and, as such, may be enforced in proceedings under applicable law.

I hope that this has been responsive to your inquiry.

Raymond Natter
Acting Chief Counsel

852—December 11, 1998

12 USC 24(7)

Dear [ ]:

This is in response to your letter dated November 24, 1998, requesting confirmation that [ ] ("bank"), may permissibly invest directly in a one-half, noncontrolling interest in [ ] *("CS"). [CS]* will be a limited liability company that will engage in servicing credit card accounts and servicing receivables to be generated by certain "private label" programs by the bank, the co-owners of *[CS]* and their affiliates. For the reasons set forth below, it is our opinion that this transaction is legally permissible in the manner and as described herein.

I. Background

The bank proposes to acquire a noncontrolling 50 percent equity interest *[CS]*. The remaining 50 percent equity interest in *[CS]* will be held by [ ] *("CC")* (which will hold a 1 percent interest in *[CS]*) and [ ] ("*MR*") (which will hold a 49 percent interest in *[CS]*). Initially, the bank will form a wholly owned limited liability company [ ] and contribute to [ ] the bank's private label merchant agreements and approximately 95 percent of its private label receivables. Immediately upon the establishment of [ ], the bank will contribute all of its ownership interest in [ ] to *[CS]*. At this point, [ ] will cease to exist and the bank will own directly a 50 percent equity interest in *[CS]*.

[CC] will contribute to *[CS]* participation interests in a pool of private label credit card accounts under a designated private label program and 95 percent of all new receivables generated under such program during the term of the joint venture with bank. Each party will contribute employees, office equipment, leases and other assets to *[CS]*. *[CC]* will be the manager of *[CS]* pursuant to the terms of a management and servicing agreement to be entered into by *[CS]* and *[CC]*. Under this agreement, *[CC]* will be responsible for *[CS]'s* daily operations, including management of employees, accounting and bookkeeping. *[CS]'s* activities will include collection, account servicing, customer service, accounting and cash settlement services.

II. Discussion

A. National Bank Express and Incidental Powers (12 USC 24(Seventh))

The bank's plan to purchase and hold a 50 percent interest in *[CS]* raises the issue of the authority of a national bank to make a noncontrolling investment in an entity. A number of recent OCC Interpretive Letters have analyzed the authority of national banks, either directly or through their subsidiaries, to own a noncontrolling interest in an enterprise. These letters each concluded that the ownership of such an interest is permissible provided four standards, drawn from OCC precedents, are satisfied.[1] They are:

1. The activities of the entity or enterprise in which the investment is made must be limited to activities that are part of, or incidental to, the business of banking;
2. The bank must be able to prevent the enterprise from engaging in activities that do not meet the foregoing standard, or be able to withdraw its investment;
3. The bank's loss exposure must be limited, as a legal and accounting matter, and the bank must not have open-ended liability for the obligations of the enterprise; and
4. The investment must be convenient and useful to the bank in carrying out its business and not a mere passive investment unrelated to *that bank's* banking business.

Based upon the facts presented, the bank's proposal satisfies these four standards.

1. The activities of the entity or enterprise in which the investment is made must be limited to activities that are part of, or incidental to, the business of banking.

Our precedents on noncontrolling ownership have recognized that the enterprise in which the bank holds an interest must confine its activities to those that are part of, or incidental to, the conduct of the banking business.[2]

As discussed above, bank has represented that *[CS]* will engage in credit card servicing. National banks have long engaged in servicing their credit card portfolios. Section 5.34(e)(2)(ii)(L) of the OCC's regulations specifically permits national banks to engage in making, purchasing, selling, servicing, or warehousing loans or other extensions of credit, or interests therein, for the subsidiary's account, or for the account of others, including credit card loans. 12 CFR 5.34(e)(2)(ii)(L) In addition, the OCC has specifically permitted national banks to hold noncontrolling equity investments in companies engaged in servicing credit card accounts as proposed here.[3] Thus, we conclude that the activities to be conducted by *[CS]* are activities that are part of, or incidental to, the business of banking.

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[1] *See, e.g.,* Interpretive Letter No. 697, *reprinted in* [1995–1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–013 (November 15, 1995); Interpretive Letter No. 732, *reprinted in* [1995–1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–049 (May 10, 1996). *See also* 12 C.F.R. § 5.36(b). National banks are permitted to make various types of equity investments pursuant to 12 USC 24(Seventh) and other statutes.

[2] *See, e.g.*, Interpretive Letter No. 380, *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,604 n.8 (December 29, 1986) (since a national bank can provide options clearing services to customers it can purchase stock in a corporation providing options clearing services); Letter from Robert B. Serino, Deputy Chief Counsel (November 9, 1992) (since the operation of an ATM network is "a fundamental part of the basic business of banking," an equity investment in a corporation operating such a network is permissible).

[3] *See, e.g.*, Conditional Approval No. 269, (January 13, 1998).

2. The bank must be able to prevent the enterprise from engaging in activities that do not meet the foregoing standard, or be able to withdraw its investment.

The activities of the enterprise in which a national bank may invest must be part of, or incidental to, the business of banking not only at the time the bank first acquires its ownership, but for as long as the bank has an ownership interest. This standard may be met if the bank is able to exercise a veto power over the activities of the enterprise, or is able to dispose of its interest. This ensures that the bank will not become involved in impermissible activities.[4]

Bank has represented to the OCC that the bank will divest its interest in *[CS]* should *[CS]* engage in any activities that are not permitted for national banks or entities in which national banks may invest.[5]

Therefore, the second standard is satisfied.

3. The bank's loss exposure must be limited, as a legal and accounting matter, and the bank must not have open-ended liability for the obligations of the enterprise.

a. Loss exposure from a legal standpoint

A primary concern of the OCC is that national banks should not be subjected to undue risk. Where an investing bank will not control the operations of the entity in which the bank holds an interest, it is important that the national bank's investment not expose it to unlimited liability. As a legal matter, investors in a Delaware limited liability company do not incur liability with respect to the liabilities or obligations of the limited liability company solely by reason of being a member or manager of the limited liability company. Del. Code Ann. Tit. 6, § 18–303 (Michie Cum. Supp. 1996).[6] Thus, the bank's loss exposure for the liabilities of *[CS]* will be limited by statute and by the agreement establishing *[CS]*.

b. Loss exposure from an accounting standpoint

In assessing a bank's loss exposure as an accounting matter, the OCC has previously noted that the appropriate accounting treatment for a bank's 20–50 percent investment in a company is to report it as an unconsolidated entity under the equity method of accounting. Under this method, unless the bank has guaranteed any of the liabilities of the entity or has other financial obligations to the entity, losses are generally limited to the amount of the investment, including loans and other advances shown on the investor's books.

As proposed, bank will have an ownership interest in *[CS]* of 50 percent. Bank will account for its investment in *[CS]* under the equity method of accounting. Thus, bank's loss from an accounting perspective would be limited to the amount invested in *[CS]* and bank will not have any open-ended liability for the obligations of *[CS]*.

Therefore, for both legal and accounting purposes, bank's potential loss exposure relative to *[CS]* should be limited to the amount of its investment in those entities. Since that exposure will be quantifiable and controllable, the third standard is satisfied.

4. The investment must be convenient and useful to the bank in carrying out its business and not a mere passive investment unrelated to that bank's banking business.

Twelve USC 24(Seventh) gives national banks incidental powers that are "necessary" to carry on the business of banking. "Necessary" has been judicially construed to mean "convenient or useful." *See Arnold Tours, Inc.* v. *Camp*, 472 F.2d 427, 432 (1st Cir. 1972). Our precedents on bank noncontrolling investments have indicated that the investment must be convenient or useful to the bank in conducting *that bank's* business. The investment must benefit or facilitate that business and cannot be a mere passive or speculative investment.[7]

You have represented that the formation of *[CS]* is a more efficient way for the bank to manage certain of its "private label" credit card receivables. The issuance of credit cards is one of the Bank's core lines of business. *[CC]* is one of the largest issuer of private label credit cards in the world. By appointing *[CC]* to manage certain of its private label programs, the bank will benefit from *[CS]'s* economies of scale and investment in systems,

[4] *See, e.g.*, Interpretive Letter No. 711, *reprinted in* [1995–1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–026 (February 3, 1996); Interpretive Letter No. 625, *reprinted in* [1993–1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,507 (July 1, 1993).

[5] In addition, the agreement establishing *[CS]* requires the approval of a majority of the Board of Directors, or the unanimous consent of all members, including the bank, in order for *[CS]* to make any significant changes to the management, structure, or activities of *[CS]*. Since one-half of the seats on the Board of Directors will be occupied by the designees of bank, bank will be able to prevent *[CS]* from making any significant changes to the management, structure, or activities of *[CS]*.

[6] Section 10.1 of the agreement establishing *[CS]* specifically provides that none of the members shall be personally liable for any debts, obligations or liabilities of *[CS]*.

[7] *See, e.g.*, Interpretive Letter No. 697, *supra*; Interpretive Letter No. 543, *reprinted in* [1990–1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,255 (February 13, 1991); Interpretive Letter No. 427, *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,651 (May 9, 1988); Interpretive Letter No. 421, *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,645 (March 14, 1988); Interpretive Letter No. 380, *supra.*

technology and infrastructure. The bank's investment in *[CS]* will be convenient and useful to bank in carrying out its business and is not a mere passive investment. Thus, the fourth standard is satisfied.

III. Conclusion

Based upon the information and representations you have provided, and for the reasons discussed above, it is our opinion that bank is legally permitted to acquire and hold a noncontrolling interest in *[CS]* in the manner and as described herein, subject to the following conditions:

1. *[CS]* will engage only in activities that are part of, or incidental to, the business of banking;
2. Bank will have effective veto power over any activities and major decisions of *[CS]* that are inconsistent with condition number one, or will withdraw from *[CS]* in the event they engage in an activity that is inconsistent with condition number one;
3. Bank will account for its investment in *[CS]* under the equity method of accounting; and
4. *[CS]* will be subject to OCC supervision, regulation, and examination.

These conditions are conditions imposed in writing by the OCC in connection with its action on the request for a legal opinion confirming that bank's investment is permissible under 12 USC 24 (Seventh) and, as such, may be enforced in proceedings under applicable law.

If you have any questions, please contact John Soboeiro, Senior Attorney, at (202) 874–5300.

Julie L. Williams
Chief Counsel

853—February 16, 1999

12 USC 24(7)

Dear [ ]:

This is in response to your letter dated December 16, 1998, supplemented by a letter dated February 4, 1999, requesting confirmation that [ ] ("bank") may lawfully acquire and hold a noncontrolling 30 percent interest in a joint venture with a mortgage company. The joint venture will be structured as a limited liability company ("LLC") and it will engage in the business of making residential mortgage loans. For the reasons set forth below, it is our opinion that this transaction is legally permissible in the manner and as described below.

I. Background

The bank proposes to hold a 30 percent noncontrolling interest in a newly formed LLC. [ ] Corporation,[1] a non-affiliate located in *[City, State],* will acquire and hold the remaining 70 percent interest. The LLC will be established under Michigan law pursuant to a written agreement between the two members, the bank and [ ]. One manager will be selected by [ ]. Otherwise, each member will have one vote on all matters reserved for member action, notwithstanding the bank's 30 percent noncontrolling equity interest. The LLC will be located in *[City],* Michigan, and will be capitalized in cash on a pro rata basis by the bank and [ ] in accordance with their investment interests ($300,000 from the bank and $700,000 from [ ]).

Under the terms of the operating agreement, no member shall be required to advance or contribute any additional funds to the LLC, except upon the unanimous consent of the members. The bank represents that in no event will its total investment in the LLC exceed 5 percent of its capital and unimpaired surplus. The LLC will engage in the business of making residential mortgage loans, and in any other activities (determined by the unanimous consent of the LLC members) permissible for limited liability companies under the applicable state law. However, the operating agreement specifically requires that any such activity must be legally permissible under the National Bank Act and any regulations or interpretive rulings issued thereunder. Moreover, as a result of its equal voting rights, the bank will have the authority to veto decisions of the LLC manager that will result in the company engaging in activities that are inconsistent with activities that are part of, or incidental to, the business of banking. The bank is also authorized to initiate the dissolution of the LLC in the event the company either: (1) engages in activities which are in violation of the National Bank Act; or (2) engages in activities which if engaged in by a national bank or a bank subsidiary would be considered a violation of the National Bank Act.

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[1] [ ] was founded in 1985 and is a mortgage company marketing conventional and sub-prime debt consolidations and home financing loans, secured by a first or second mortgage on one-to-four family, owner occupied residences. It originates through approximately 26 offices (18 in *[State])* and through its marketing and call centers. In 1997, [ ]'s conventional mortgage lending division originated over 6,500 loans totaling more than $867 million, and its subprime and high LTV second mortgage paper divisions, on a combined basis, originated over 6,100 loans totaling more than $335 million.

The LLC will be the mechanism through which the bank will continue to offer residential mortgage loans to its current and prospective customers.[2] These loans will be closed in the name of the LLC and will be funded by the LLC through a mortgage warehousing and security agreement between the bank and the LLC. Funds will be disbursed at the offices of third parties. The bank represents that this arrangement will be structured and maintained as an arm's length transaction, subject to the lending limits of 12 USC 84 as well as 12 CFR Part 32. It is anticipated that the LLC will either: (1) sell loans it originates to [ ], which will then resell the loans in the secondary market or to its investors; or (2) establish direct correspondent relationships and sell loans it originates to such investors, including the bank as an investor. In the latter case, the bank will purchase for its portfolio subject to a correspondent/investor agreement and the transaction will be structured and maintained as an arm's length transaction.[3]

The bank may provide administrative services to the LLC under a services agreement. Likewise, [ ] will provide loan processing services to the LLC under a services agreement. Some LLC employees will be physically located at designated bank branch locations. The bank represents that it will in all cases adhere to the supervisory conditions and guidance for sharing space and guidance contained in 12 CFR 7.3001.[4]

II. Discussion

A. National Bank Express and Incidental Powers (12 USC 24(Seventh))

In a variety of circumstances the OCC has permitted national banks to own, either directly, or indirectly through an operating subsidiary, a noncontrolling interest in an enterprise. The enterprise might be a limited partnership, a corporation, or a limited liability company.[5] In recent interpretive letters, the OCC concluded that national banks are legally permitted to make a noncontrolling investment in a limited liability company provided four criteria or standards are met.[6] These standards, which have been distilled from our previous decisions in the area of permissible noncontrolling investments for national banks and their subsidiaries, are: (1) The activities of the entity or enterprise in which the investment is made must be limited to activities that are part of, or incidental to, the business of banking; (2) The bank must be able to prevent the enterprise or entity from engaging in activities that do not meet the foregoing standard or be able to withdraw its investment; (3) The bank's loss exposure must be limited, as a legal and accounting matter, and the bank must not have open-ended liability for the obligations of the enterprise; and (4) The investment must be convenient or useful to the bank in carrying out its business and not a mere passive investment unrelated to that bank's banking business.

Based upon the facts presented, the bank's proposal satisfies these four standards.

1. The activities of the entity or enterprise in which the investment is made must be limited to activities that are part of, or incidental to, the business of banking.

Our precedents on noncontrolling ownership have recognized that the enterprise in which the bank holds an

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[2] The bank currently makes, buys and sells residential mortgage loans through its in-house Residential Mortgage Banking Department. The bank desires to restructure this aspect of its business into the LLC so that it can continue to offer the same types of mortgage loans while allowing for expanded operations in the future through the LLC. It is anticipated that the LLC will have originations of 4,100 loans totaling $453 million at the end of its first full 12 months of operation. The current pro forma projects that subprime loans will comprise approximately 7.5 percent of the total loan volume, or $34 million.

[3] The bank anticipates this will be limited to purchasing existing proprietary residential loan products with features that prevent resale on the secondary market as well as occasional accommodation loans to established customers. The bank has represented that it will first conduct a review of all loans to be purchased utilizing its independent standards and that it will not purchase any subprime loans from the LLC.

[4] The bank notes that the arrangement between the LLC and itself in conducting mortgage lending services will likely constitute an "affiliated business arrangement" ("ABA"), as defined under the Real Estate Settlement and Procedures Act of 1974 ("RESPA"). The proposed transaction will be structured such that all activities will fully comply with RESPA and all applicable regulations, including specifically the ABA rules.

[5] *See also* 12 CFR 5.36(b). National banks are permitted to make various types of equity investments pursuant to 12 USC 24(Seventh) and other statutes.

[6] *See* OCC Interpretive Letter No. 692 (November 1, 1995), *reprinted in* [1995–1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,007, and No. 694 (Dec. 13, 1995), *reprinted in* [1995–1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,009. *See also* Letter of Steven J. Weiss, Deputy Comptroller, Bank Organization and Structure (December 27, 1995 unpublished) ("Weiss Letter"). In other recent letters, the OCC has permitted national banks to make a noncontrolling investment in an enterprise other than an LLC, provided the investment satisfies these four standards. *See e.g.*, OCC Interpretive Letter No. 697 (November 15, 1995), *reprinted in* [1995–1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,012; OCC Interpretive Letter No. 705 (October 25, 1995), *reprinted in* [1995–1996 Transfer Binder] Fed. Banking L. Rep. ¶ 81,020.

interest must confine its activities to those that are part of, or incidental to, the conduct of the banking business.[7]

The LLC will originate and sell residential real estate mortgage loans. It is clear that these activities are legally permissible under 12 USC 24 (Seventh) (general ability of national banks to make loans) and 12 USC 371 (ability of national banks to make, arrange, purchase or sell loans or extensions of credit secured by liens on interests in real property).[8]

Accordingly, the first standard is met.

2. The bank must be able to prevent the enterprise from engaging in activities that do not meet the foregoing standard, or be able to withdraw its investment.

The activities of the enterprise in which a national bank may invest must be part of, or incidental to, the business of banking not only at the time the bank first acquires its ownership, but for as long as the bank has an ownership interest. This standard may be met if the bank is able to exercise a veto power over the activities of the enterprise, or is able to dispose of its interest.[9] This ensures that the bank will not become involved in impermissible activities.

Pursuant to the proposed operating agreement, the LLC will not engage in activities which would be impermissible for the bank or a subsidiary of the bank. Also, the bank will have the authority to veto activities or decisions by the LLC's manager that are inconsistent with activities that are part of, or incidental to, the business of banking, as determined by the OCC.[10] This provision will enable the bank on an ongoing basis to prevent the LLC from engaging in new activities which may be impermissible. Furthermore, the operating agreement authorizes the bank to terminate the agreement and dispose of its interest in the LLC if the company engages in any activities that are not part of, or incidental to, the business of banking.

Therefore, the second standard is satisfied.

3. The bank's loss exposure must be limited, as a legal and accounting matter, and the bank must not have open-ended liability for the obligations of the enterprise.

a. Loss exposure from a legal standpoint

A primary concern of the OCC is that national banks should not be subjected to undue risk. Where an investing bank will not control the operations of the entity in which the bank holds an interest, it is important that the national bank's investment not expose it to unlimited liability. As a legal matter, investors in a Michigan limited liability company will not incur liability with respect to the liabilities or obligations of the limited liability company solely by reason of being a member or manager of the limited liability company—even if they actively participate in the management of control of the limited liability company.[11] The legal structure of the LLC will ensure that the bank is shielded from unlimited liability with respect to the LLC. Thus, the bank's loss exposure for the liabilities of the LLC will be limited by statute.

b. Loss exposure from an accounting standpoint

In assessing a bank's loss exposure as an accounting matter, the OCC has previously noted that the appropriate accounting treatment for a bank's 20–50 percent ownership share of investment in a limited liability company is to report it on an unconsolidated basis. Under the equity method of accounting, unless the bank has guaranteed any of the liabilities of the entity or has other financial obligations to the entity, losses are generally limited to the amount of the investment, including loans and other advances shown on the investor's books.[12]

As proposed, the bank will have a 30 percent ownership interest in the LLC. The bank will account for its investment in the LLC under the equity method. Under the operating agreement, an unrepaid capital contribution is not a liability of the LLC or of any member. A member is not required to contribute or to lend any cash or property to the LLC to enable it to return any member's capital contribution. Thus the bank's loss from an accounting perspective would be limited to the amount invested in the LLC and the bank will not have any open-ended liability for the obligations of the LLC.

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[7] *See, e.g.*, OCC Interpretive Letter No. 380, *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,604 n.8 (December 29, 1986) (since a national bank can provide options clearing services to customers it can purchase stock in a corporation providing options clearing services); Letter from Robert B. Serino, Deputy Chief Counsel (November 9, 1992) (since the operation of an ATM network is "a fundamental part of the basic business of banking," an equity investment in a corporation operating such a network is permissible).

[8] *See* OCC Interpretive Letter No. 645, (April 29, 1994), *reprinted in* [1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,554.

[9] *See, e.g.*, OCC Interpretive Letter No. 711, *reprinted in* [1995–1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–026 (February 3, 1996); OCC Interpretive Letter No. 625, *reprinted in* [1993–1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,507 (July 1, 1993).

[10] The operating agreement also provides that the LLC will be subject to OCC supervision, regulation and examination.

[11] Mich. Comp. Laws. Ann. § 450.4501(2) (West 1997).

[12] *See generally,* Accounting Principles Board, Op. 18 § 19 (1971) (equity method of accounting for investments in common stock); OCC Interpretive Letter No. 692, *supra.*

Therefore, for both legal and accounting purposes, the bank's potential loss exposure relative to the LLC should be limited to the amount of its investment in those entities. Because the bank will not have open-ended liability for the liabilities of the LLC and its exposure will be quantifiable and controllable, the third standard is satisfied.

4. The investment must be convenient and useful to the bank in carrying out its business and not a mere passive investment unrelated to that bank's banking business.

A national bank's investment in an enterprise or entity must also satisfy the requirement that the investment have a beneficial connection to the bank's business, *i.e.,*be convenient or useful to the investing bank's business activities, and not constitute a mere passive investment unrelated to that bank's banking business. Twelve USC 24(Seventh) gives national banks incidental powers that are "necessary" to carry on the business of banking. "Necessary" has been judicially construed to mean "convenient or useful".[13] Our precedents on bank noncontrolling investments have indicated that the investment must be convenient or useful to the bank in conducting *that bank's* business. The investment must benefit or facilitate that business and cannot be a mere passive or speculative investment.[14]

The bank is currently actively involved in the mortgage lending business and intends to remain so, through its involvement in the LLC. The bank believes the best way for it to continue to offer a ready source of residential mortgage lending services to its customers and prospective customers is to become a member of an LLC with another established mortgage lender such as [ ]. Although the bank will not make residential mortgage loans itself, it will refer bank customers and prospective customers to the LLC. Thus, the bank is not exiting this line of business. Rather, it is seeking to create a channel whereby it can provide an increased level of residential mortgage lending services it believes its customers desire. Furthermore, the bank represents that this transaction will not result in a passive investment, as it will play an active and significant role in the LLC. The bank reiterates that there are only two members in the LLC—[ ] and itself—which suggests that this will not be a passive investment. For these reasons, the bank's investment in the LLC is convenient and useful to the bank in carrying out its business and is not a mere passive investment. Thus, the fourth standard is satisfied.

B. Affiliate Relationship Between the Bank and LLC

You have also requested our opinion with regard to the affiliate status of the LLC under Sections 23A and 23B of the Federal Reserve Act, 12 USC 371c and 371c–1, as well as under the Community Reinvestment Act.

1. Transactions with Affiliates

Sections 23A and 23B place restrictions on certain transactions between a bank (and its subsidiaries) and its affiliates. These restrictions appear not to apply to extensions of credit made by the bank to the LLC[15] and loan purchases by the bank from the LLC since the bank's 30 percent ownership of the LLC will qualify the LLC as a subsidiary of the bank for purposes of both section 23A and section 23B[16] and nonbank subsidiaries are excluded from the definition of "affiliate" in these provisions.[17]

2. Community Reinvestment Act

The OCC's regulation implementing the Community Reinvestment Act, 12 USC 2901, *et seq.* ("CRA"), allows a bank to include loans made by its affiliates for consideration during an evaluation of its CRA record.[18] By virtue of the bank's 30 percent ownership interest, the LLC meets the definition of "affiliate" under the OCC's CRA regulation.[19] Accordingly, the bank may elect to have the OCC consider home mortgage loans made by the LLC when evaluating the bank's performance under the CRA regulation's lending test, subject to the limitations and conditions contained in 12 CFR 25.22(c).

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[13] *See Arnold Tours, Inc. v. Camp*, 472 F.2d 427, 432 (1st Cir. 1972).

[14] *See, e.g.*, OCC Interpretive Letter No. 697, *supra*; OCC Interpretive Letter No. 543, *reprinted in* [1990–1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,255 (February 13, 1991); OCC Interpretive Letter No. 427, *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,651 (May 9, 1988); OCC Interpretive Letter No. 421, *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,645 (March 14, 1988); OCC Interpretive Letter No. 380, *supra.*

[15] As you noted in your letters, extensions of credit from the bank to the LLC will be subject to the lending limits established by 12 USC 84 and 12 CFR Part 32.

[16] Under section 23A a "subsidiary" is a company that is controlled by another company, 12 USC 371c(b)(4); and a company is deemed to control another company if, inter alia, it has the power to vote 25 percent or more of any class of voting securities of that company, 12 USC 371c(b)(3)(A)(i). The position is the same under section 23B. *See* 12 USC 371c–1(d)(2).

[17] 12 USC 371c(b)(2)(A), 371c–1(d)(1). This exclusion from sections 23A and 23B is subject to the authority of the Federal Reserve Board to determine, in certain circumstances, that a company, including a nonbank subsidiary, is an affiliate. *See* 12 USC 371c(b)(1)(E), (2)(A).

[18] 12 CFR 25.22(c)(1).

[19] 12 CFR 25.12(a) defines an affiliate as "any company that controls, is controlled by, or is under common control with another company." For purposes of this definition, the term "control" is defined at 12 USC 1841(a)(2)(A) as the ownership, control or power to vote 25 percent or more of any class of voting securities of that company.

III. Conclusion

Based upon the information and representations you have provided in your letters of December 16, 1998 and February 4, 1999, and for the reasons discussed above, it is our opinion that the bank is legally permitted to acquire and hold a noncontrolling minority interest in the LLC in the manner and as described herein, subject to the following conditions:

1. the LLC will engage only in activities that are part of, or incidental to, the business of banking;
2. the bank will have veto power over any activities and major decisions of the LLC that are inconsistent with condition number one, or will withdraw from the LLC in the event they engage in an activity that is inconsistent with condition number one;
3. the bank will account for its investment in the LLC under the equity method of accounting; and
4. the LLC will be subject to OCC supervision, regulation and examination.

These conditions are conditions imposed in writing by the OCC in connection with its action on the request for a legal opinion confirming that the proposed investment is permissible under 12 USC 24(Seventh) and, as such, may be enforced in proceedings under applicable law.

If you have any questions, please contact me or Roger Bainbridge, Senior Attorney at (312) 360–8805.

Coreen S. Arnold
District Counsel
Central District Office
One Financial Place, Suite 2700
440 South LaSalle Street
Chicago, IL 60605

854—February 25, 1999

12 USC 24(7)

Dear [ ]:

This is in response to your letter of January 20, 1999, requesting confirmation that several national banks (“the banks”)[1] may acquire and hold noncontrolling equity investments in an electronic funds transfer (“EFT”) network. The banks currently are noncontrolling investors in an EFT network that plans to merge with another EFT network, and they wish to continue as noncontrolling investors in the network resulting from the merger.[2] For the reasons set forth below, it is my opinion that the banks may acquire and hold noncontrolling equity investments in the merged network, in the manner and as described herein.

A. The Transaction

Star System, Inc. (“Star”) is a California nonprofit mutual benefit corporation[3] headquartered in San Diego, California. As of November 30, 1998, Star was owned by 17 financial depository institution or depository institution holding company members, including the banks. Star operates the Star Network, which provides automated teller machine (“ATM”), point of sale (“POS”), and EFT services to customers primarily located in 12 western states.[4] Honor Technologies, Inc. (“Honor”) is a Delaware stock corporation headquartered in Maitland, Florida. As of November 30, 1998, Honor was owned by 36 depository institution holding company shareholders. Honor operates the HONOR Network and the HONOR West Network, which together provide services comparable to the Star Network in 22 primarily southeastern states and the District of Columbia.[5]

Star and Honor have agreed to merge according to the following plan (“the merger”). A new Delaware stock corporation known as H&S Holding Company, Inc. (“H&S”) has been formed, headquartered in Maitland, Florida.

[1] The national banks joining in this request are *[Bank 1]; [Bank 2]; [Bank 3];* and *[Bank 4].*

[2] Certain bank holding companies that own equity interests in the current networks filed a comparable application with the Board of Governors of the Federal Reserve System (“the Board”) pursuant to section 4(c)(8) of the Bank Holding Company Act, 12 USC 1843(c)(8), and the Board’s Regulation Y, 12 CFR 225.23. You supplied the OCC with a copy of that application and incorporated it by reference in your request letter. Accordingly, this letter relies in part upon facts and representations contained in that application. The Board approved the application by order dated February 1, 1999.

[3] Such a corporation is organized under the California Nonprofit Mutual Benefit Corporation Law and is characterized by having members and memberships rather than shareholders and shares of stock. *See generally* Cal. Corp. Code §§ 7110 *et. seq.* (West 1990).

[4] As of September 1998, Star had approximately 1,013 member and affiliate depository institutions participating in the network, consisting of 435 banks, 64 savings institutions, and 514 credit unions. At that time, the network included approximately 44,257 ATMs and approximately 627,069 POS terminals.

[5] As of September 1998, the HONOR Network had a total of 2,613 participating depository institutions, consisting of 1,813 banks, 165 savings institutions, and 635 credit unions. As of July 1998, there were 56,941 ATMs and more than 400,000 POS terminals in the network. As of September 1998, HONOR West had 868 participating depository institutions, consisting of 696 banks, 13 savings institutions, and 159 credit unions, and included 6,708 ATMs and approximately 26,500 POS terminals.

("H&S" is a provisional name; a permanent name will be chosen later.) H&S will acquire ownership of Star and Honor through an exchange of stock with their current owners. The banks will each exchange their current membership interests in Star for [ ] per cent of the stock of H&S, and thus will become minority investors in H&S.[6] As a result of this exchange, Star and Honor will become wholly owned subsidiaries of H&S. They will continue to operate the Star, HONOR, and HONOR West Networks ("the networks"). (Although it is envisioned that the networks ultimately will be combined, initially the networks will retain their individual identities.) H&S will be governed by a 30-person board of directors, consisting of 14 directors elected by current Honor shareholders, 14 elected by current Star members, and 2 directors who will be the current presidents of Star and Honor.

H&S will engage in a broad range of EFT-related activities including operating the networks, data processing, and providing consulting services to depository institutions.[7] H&S will also own equity interests in two companies that provide services related to debit card security and check verification, respectively. These activities are discussed in more detail in the following section.

B. Analysis

The banks' letter raises the issue of the ability of national banks to own a noncontrolling equity interest in an enterprise. In a variety of circumstances, the OCC has permitted national banks to own, either directly as proposed here, or indirectly through operating subsidiaries, such minority interests.[8] The OCC has concluded that national banks are legally permitted to make minority equity investments provided that four criteria are satisfied. These standards are:

(1) The activities of the enterprise in which the investment is made must be limited to activities that are part of, or incidental to, the business of banking.

(2) The bank must be able to prevent the enterprise from engaging in activities that do not meet the foregoing standard, or be able to withdraw its investment.

(3) The bank's loss exposure must be limited, as a legal and accounting matter, and the bank must not have open-ended liability for the obligations of the enterprise.

(4) The investment must be convenient or useful to the bank in carrying out its business and not a mere passive investment unrelated to that bank's banking business.

We conclude, as discussed below, that the banks' proposed investment in H&S satisfies these four criteria.

1. The activities of the enterprise in which the investment is made must be limited to activities that are part of, or incidental to, the business of banking.

The National Bank Act, in relevant part, provides that national banks shall have the power:

> [t]o exercise . . . all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes . . . .

The Supreme Court has held that this powers clause of 12 USC 24(Seventh) is a broad grant of power to engage in the business of banking, which is not limited to the five enumerated powers. Further, national banks are authorized to engage in an activity if it is incidental to the performance of the enumerated powers in section 24(Seventh) *or* if it is incidental to the performance of an activity that is part of the business of banking.[9] Since national banks must be able to make use of modern technology in performing their business, the OCC's Interpretive Ruling 7.1019, 12 CFR 7.1019, permits national banks to "perform, provide, or deliver through electronic means and facilities any activity, function, product, or service that [they are] otherwise authorized to perform, provide, or deliver."

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[6] There is a fifth national bank investor in Star, *[Bank 5]*. However, following the merger, its shares of H&S will be immediately transferred by dividend to its holding company, [ ] Corporation. Accordingly, *[Bank 5]* has not joined the banks in the present request.

[7] Although H&S will maintain records of transactions necessary for auditing purposes, you have represented that this information will not be identifiable by customer names or Social Security numbers. You have also represented that H&S will not collect, maintain, or disclose to third parties private transaction-related information relating to identifiable customers, and that appropriate data security procedures are in place or will be implemented to protect confidential information.

[8] *See, e.g.,* Conditional Approval No. 293, November 24, 1998; OCC Interpretive Letter No. 771, *reprinted in* [1996–1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–135 (February 24, 1997); Conditional Approval No. 221, December 4, 1996; OCC Interpretive Letter No. 720, *reprinted in* [1995–1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–035 (January 26, 1996); OCC Interpretive Letter No. 697, *reprinted in id.* ¶ 81–012 (November 15, 1995).

[9] *NationsBank of North Carolina, N.A.* v. *Variable Annuity Life Ins. Co.,* 513 U.S. 215 (1995).

The general activities of H&S, through the networks, will be to develop, operate, manage, and market to financial institutions, processors, retailers, and consumers, products and processing services for transactions conducted at electronic terminal devices, including but not limited to ATMs, POS terminals, scrip terminals,[10] and similar devices. These are permissible banking or correspondent services. Indeed, the OCC has already found that all of the specific activities in which H&S will engage are permissible for national banks. Moreover, the banks, through Star, are already engaged in most of these activities (exceptions are noted in the footnotes). Therefore, to a large extent, the merger will merely constitute a change of form for the banks' current activities. Accordingly, this letter will only describe briefly the various activities in which H&S will engage, with citations to OCC precedent for each activity. Please refer to the cited precedents for a more complete discussion of the legal authority for each activity.

The proposed activities are as follows:

i. *ATM services.* H&S will provide data processing services in connection with ATM transaction requests for withdrawals from accounts, cash advances from lines of credit and credit card accounts, deposit account balance inquiries, transfers between checking and savings accounts and, to the extent permitted by law, deposit taking. (Individual financial institution participants will decide whether their customers will be permitted to make deposits at Network ATMs.)[11]

ii. *On-line and off-line POS services.* Data processing services in connection with on-line and off-line POS transaction requests.[12]

iii. *Point of Banking ("POB") services.* H&S will provide data processing services in connection with transactions originated at POB terminals. At POB terminals, customers of participating financial institutions can conduct the same types of transactions available at ATMs. POB terminals differ from ATMs in that a third party (usually an employee of the merchant at whose retail location the POB terminal is deployed) assists the customer in accessing the EFT service. Bill payment is also usually available at POB terminals.[13]

iv. *Scrip services.* Data processing services in connection with transactions originating at scrip terminals.[14]

v. *Gateway services.* H&S will provide data processing arrangements that will allow H&S to route transaction requests for participants between the networks and other EFT networks, including both ATM and POS networks. In the case of ATM-related activities, this routing will permit customers of each Network's participating financial institutions to access their accounts at terminals in the other networks.[15]

vi. *Other gateway services.* H&S will operate and support communication links for ATM, POS, and related transactions between individual financial institutions and affiliates, and other regional EFT networks, national networks such as Visa and MasterCard, and other card issuing organizations. These other gateway services will be very similar to those provided as part of the EFT network gateway access services.[16]

vii. *Group purchasing.* H&S will purchase EFT-related supplies such as signage, statement stuffers, and terminals, in bulk for the benefit of participants.[17]

viii. *ATM terminal driving.* H&S will provide ATM terminal driving (*i.e.*, operating) services to participating financial institutions, merchants, and other businesses.[18]

ix. *Card production, issuance, and related functions.* H&S will provide a full service card production facility, together with card issuance support and card database management.[19]

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[10] A scrip terminal is a dedicated terminal that dispenses a cash equivalent, such as a voucher, that can be redeemed for goods or services at designated merchants.

[11] OCC Interpretive Letter No. 381, *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,605 (May 5, 1987); OCC Interpretive Letter No. 289, *reprinted in* [1983–1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,453 (May 15, 1984); OCC Interpretive Letter No. 153, *reprinted in* [1981–1982 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,234 (July 7, 1980).

[12] Letter of Robert B. Serino, Deputy Chief Counsel (November 9, 1992) (unpublished).

[13] *See* notes 11 and 12, *supra.* Star does not currently engage in this activity, therefore this will be a new activity for the banks.

[14] OCC Interpretive Letter No. 718, *reprinted in* [1995–1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–033 (March 14, 1996); OCC Interpretive Letter No. 705, *reprinted in id.* ¶ 81–020 (October 25, 1995).

[15] OCC Interpretive Letter No. 382, *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,606 (May 5, 1987); *see* OCC Interpretive Letter No. 346, *reprinted in* [1985–1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,516 (July 31, 1985) (gateway services for financial settlement of commodities transactions).

[16] *Id.*

[17] OCC Interpretive Letter No. 705, *supra* note 14; No-Objection Letter No. 87–11, *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 84,040 (November 30, 1987).

[18] *See* note 11, *supra*. Star does not currently engage in this activity, therefore this will be a new activity for the banks.

[19] *See* note 17, *supra*. Star does not currently engage in this activity, therefore this will be a new activity for the banks.

x. *Electronic benefit transfer ("EBT") services.* H&S will provide EBT services that will enable ATMs, POS terminals, and other similar devices connected to H&S' data processing systems to be used to deliver government welfare benefits to qualified recipients. Such payments might include food stamps, unemployment assistance, social security, and aid to families with dependent children, which are for the most part currently distributed by check, coupon, or stamp.[20]

xi. *Automated clearinghouse ("ACH") processing.* H&S will act as a regional ACH processor for the southeast and mid-Atlantic United States, which would include the states of Alabama, Florida, Georgia, South Carolina, North Carolina, Virginia, Maryland, Tennessee, and the District of Columbia.[21]

xii. *Electronic bill payment and home banking.* H&S will offer home banking and electronic payment systems to financial institutions that they, in turn, can offer to their customers as part of an enhanced account services portfolio. The services are currently provided through an arrangement with a third party vendor, and will not be offered or marketed directly to account holders. The electronic bill payment and home banking services enable account holders to obtain account information, transfer funds between accounts, or pay bills to participating merchants or others. These services may be accessed through various means, including telephone, personal computer, or the Internet. Internet access is accomplished by installing a hyperlink in the financial institution Web site to the contractor's electronic bill payment and home banking Web page, which can be accessed by subscribing financial institution customers. H&S will not sell any hardware to any financial institution customers, and will not be an Internet service provider.[22]

xiii. *Check verification.* H&S will offer check verification services as an ancillary service to its ATM and POS-related services. These services will be provided by Primary Payment Systems, Inc. ("PPS"), a Delaware corporation that, after the mergers, will be a majority-owned subsidiary of H&S (as successor in interest to Star). PPS's principal service is to provide participating financial institutions access to a database that contains the status of over 80 million checking accounts. This information warns financial institutions of possible check returns and enables them to make appropriate "funds hold" decisions. These decisions are based on an electronic verification of the checking account which includes a positive verification of the account's existence and multiple other status codes such as account closed, insufficient funds, and others, to prevent the early release of uncollected funds. PPS also provides certain account status information to check acceptance companies who provide check verification and guarantee services to merchants.[23]

xiv. *Proprietary ATM services for non-financial entities.* H&S will provide proprietary ATM services for non-financial entities that will include driving EFT devices owned by financial or non-financial entities; providing EFT account authorizations for customers of non-financial entities; processing EFT transactions to permit non-financial entity participants in one EFT network to gain access to other EFT networks; monitoring EFT networks and devices to enable accurate and secure transmission of data for non-financial entities; telephone banking services such as telephone bill payment services; and providing EFT-related support and maintenance services to non-financial entities.[24]

xv. *Private financial network services.* This service consists of telecommunications network services, used to link ATMs, that are resold to participating financial institutions, retail merchants, and other customers of H&S in conjunction with other EFT services. These services, however, will be discontinued in the near future.[25]

xvi. *Card fraud detection services.* Following the merger, H&S will become a minority owner (as successor in interest to Star and Honor) of Card Alert Services, Inc. ("CAS"), a Delaware corporation that provides a debit card anti-fraud system. It seeks to create and maintain a nationwide electronic database of debit card fraud information that will be used to: (i) provide early warning to financial institutions and EFT

[20] OCC Interpretive Letter No. 718, *supra* note 14.

[21] Letter of Julie L. Williams, Chief Counsel (May 16, 1997) (unpublished); OCC Interpretive Letter No. 419, *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,643 (February 16, 1988).

[22] Conditional Approval No. 221, *supra* note 8; OCC Interpretive Letter No. 742, *reprinted in* [1996–1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–106 (August 19, 1996); OCC Interpretive Letter No. 611, *reprinted in* [1992–1993 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,499 (November 23, 1992). Star does not currently engage in this activity, therefore this will be a new activity for the banks.

[23] Conditional Approval No. 287 (September 4, 1998); letter of John E. Shockey, Deputy Chief Counsel (June 7, 1976) (unpublished).

[24] No-Objection Letter No. 87–11, *supra* note 17.

[25] OCC Interpretive Letter No. 513, *reprinted in* [1990–1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,215 (June 13, 1990).

networks of multiple-card counterfeit fraud; (ii) determine the dimensions of the fraud, distinguishing multiple-card incidents from single-card incidents and determining the magnitude of the exposure; (iii) identify suspect cards (both cards already used and cards in the perpetrator's inventory), allowing action to be taken to contain losses; and (iv) provide a central data base of fraud information to support investigative efforts and fraud level monitoring and reporting. All of the information involved in the data processing activities related to the CAS system will be banking, financial, or economic data.[26]

xvii. *Consulting services.* H&S will offer EFT consulting services to both member and non-member depository institutions to assist such institutions in areas such as ATM site selection; card design; EFT program graphics; customer and employee education and promotion; strategic EFT marketing planning and advertising; and public relations planning. H&S will also offer consulting services related to EFT operations, disaster recovery, and security to member and non-member depository institutions, which may include, among other things: hardware and software selection; selection and installation of ATMs, POS terminals, and other similar devices; telecommunications; plastic card production, encoding, and distribution; transaction set selection; EFT security and fraud prevention; and organize and coordinate EFT research studies sponsored by participating depository institutions.[27]

H&S will also offer consulting services on Web page design and development and Web service hosting. These services will involve designing and creating Web pages from selected Web page templates and hosting such Web pages through a third party Web server under contract with H&S. H&S also anticipates providing annual Web page maintenance services to enable financial institutions to correct errors, amend, and/or update the Web the Web sites hosted by H&S's third party Web server. All Web hosting services will be offered through a third party contractor, and will not be performed directly by H&S.[28]

2. The bank must be able to prevent the enterprise from engaging in activities that do not meet the foregoing standard, or be able to withdraw its investment.

This is an obvious corollary of the first standard. It is not sufficient that the entity's activities are permissible at the time a bank initially acquires its interest; they must also remain permissible for as long as the bank retains an ownership interest.

Minority shareholders in a corporation do not possess a veto power over corporate activities as a matter of corporate law. Moreover, under the proposed bylaws of H&S ("proposed by-laws"), no shareholder is entitled to name more than one director.[29] Thus, the banks lack the ability to restrict the activities of H&S to only those that are bank permissible. In addition, the proposed by-laws do not currently contain any provision limiting the activities of H&S to those that are bank permissible. Accordingly, you have represented that the managements of Star and Honor have committed that, prior to the consummation of the merger, they will effect the necessary changes in the proposed by-laws to impose such a limitation.

Nevertheless, the banks have the ability to withdraw their investments in H&S should that become necessary. While the governing provisions are complex, the proposed by-laws generally provide that shareholders have the right to transfer their shares to other shareholders or to H&S, itself. Shares may also be transferred to non-shareholder depository institutions or depository institution holding companies, subject to a right of first refusal on the part of other shareholders and H&S. The proposed by-laws also recognize that a shareholder may transfer its shares if re-

[26] The OCC has long held that national banks may collect, transcribe, process, analyze, store, and make available to others, banking, financial, or other economic data. *See, e.g.*, OCC Interpretive Letter No. 741, *reprinted in* [1996–1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–105 (August 19, 1996) (automobile dealer inventory database); OCC Interpretive Letter No. 653, *reprinted in* [1994–1995 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,601 (December 22, 1994) (insurance agent database); OCC Interpretive Letter No. 516, *reprinted in* [1990–1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,220 (July 12, 1990) (electronic database of information on financial instruments, domestic and international financial markets, economic information and news).

[27] These are all activities which national banks may perform directly. *See, e.g.*, No-Objection Letter No. 87–11, *supra* note 17; note 26, *supra.* Therefore, it is also permissible to provide consulting services concerning these activities. OCC Interpretive Letter No. 137, *reprinted in* [1981–1982 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,218 (December 27, 1979).

[28] *See* OCC Interpretive Letter No. 805, *reprinted in* [1997–1998 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–252 (October 9, 1997) (providing electronic imaging services to banks and other financial institutions); OCC Interpretive Letter No. 754, *reprinted in* [1996–1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–118 (November 6, 1996) (computer network consulting and support). Star does not currently engage in Web page design and development or Web service hosting, therefore these will be new activities for the banks.

[29] Specifically, the proposed by-laws provide that each director must be an executive level officer, or equivalent, of a shareholder, but no more than one director may be such an officer of any one shareholder. Art. III, § 1.

quired to do so by a regulatory agency.[30] These provisions appear adequate to permit the banks to withdraw their investment in H&S. Accordingly, the second standard is satisfied.

3. The bank's loss exposure must be limited, as a legal and accounting matter, and the bank must not have open-ended liability for the obligations of the enterprise.

a. Loss exposure from a legal standpoint

A primary concern of the OCC is that national banks should not be subjected to undue risk. Where an investing bank will not control the operations of the entity in which the bank holds an interest, it is important that the national bank's investment not expose it to unlimited liability. Normally, this is not a concern when a national bank invests in a corporation, for it is generally accepted that a corporation is an entity distinct from its shareholders, with its own separate rights and liabilities, provided proper corporate separateness is maintained.[31] This is the case here. The corporate veil of H&S will protect the banks from liability or loss associated with their ownership interests in H&S.[32]

b. Loss exposure from an accounting standpoint

In assessing a bank's loss exposure as an accounting matter, the OCC has previously noted that the appropriate accounting treatment for a bank's less than 20 percent ownership share or investment in a corporate entity is to report it as an unconsolidated entity under the equity or cost method of accounting. Under the equity method of accounting, unless the investor has extended a loan to the entity, guaranteed any of its liabilities, or has other financial obligations, the investor's losses are generally limited to the amount of the investment shown on the investor's books.[33] You have represented that the banks will account for their ownership interests in H&S according to generally accepted accounting principles, which will satisfy the OCC's requirements in this regard.

Therefore, for both legal and accounting purposes, the banks' potential loss exposure arising from their respective investments in H&S should be limited to the amount of those investments. Since that exposure will be quantifiable and controllable, the third standard is satisfied.

[30] *See generally* Proposed By-Laws, art. II, section 13.

[31] 1 W. Fletcher, Cyclopedia of the Law of Private Corporations § 25 (rev. perm. ed. 1990).

[32] Del. Code Ann. tit. 8, § 102(b)(6) (Michie 1991).

[33] *See generally,* Accounting Principles Board, Op. 18 ¶ 19 (1971).

4. The investment must be convenient or useful to the bank in carrying out its business, and not a mere passive investment unrelated to that bank's banking business.

Twelve USC 24(Seventh) gives national banks incidental powers that are "necessary" to carry on the business of banking. "Necessary" has been judicially construed to mean "convenient or useful."[34] Further, the provision in 12 USC 24(Seventh) relating to the purchase of stock does not authorize speculative investment banking activities in connection with stock. Therefore, a consistent thread running through our precedents concerning a national bank's investment in an enterprise or entity that is not an operating subsidiary is that it must be convenient or useful to the bank in conducting its banking business. The investment must benefit or facilitate that business and cannot be a mere passive or speculative investment.

According to your letter, the primary purpose of H&S and the networks will be to permit customers of participating financial institutions, including the banks, (i) to perform banking transactions through ATMs, and (ii) to allow the transfer of funds from the accounts of cardholders, who have accounts in member institutions, to the accounts of participating retailers through POS terminals. The OCC has recognized that such activities are a "fundamental part of the basic business of banking."[35] Indeed, any bank that did not make these services available to its customers in today's economy would be at a serious competitive disadvantage. The banks' ownership of H&S stock will both facilitate their participation in the networks, and allow them to influence and supervise the services provided by the networks. Therefore, the investments by the banks in H&S will be "convenient or useful" to the core businesses of the banks, and not a passive or speculative activity. Accordingly, the fourth standard is satisfied.

C. Conclusion

Based upon a thorough review of the information you provided, including the representations and commitments made both in your letter and in the Board filing incorporated therein by reference, and for the reasons discussed above, we conclude that the banks may acquire noncontrolling equity investments in H&S in exchange for their current noncontrolling equity investments in Star pursuant to the merger, subject to the following conditions:

(1) H&S and its subsidiaries will engage only in activities that are part of, or incidental to, the business of banking;

[34] *Arnold Tours, Inc.* v. *Camp,* 472 F.2d 427, 432 (1st Cir. 1972).

[35] Letter of Robert B. Serino, *supra* note 12; *see* OCC Interpretive Letter No. 419, *supra* note 21.

(2) the banks will withdraw their investments from H&S in the event that H&S or its subsidiaries engage in an activity that is inconsistent with condition number one;

(3) the banks will account for their respective investments in H&S under the equity or cost method of accounting; and

(4) H&S and its subsidiaries will be subject to OCC supervision, regulation, and examination.

These conditions are conditions imposed in writing by the OCC in connection with its action on the banks' request for a legal opinion confirming that their respective investments are permissible under 12 USC 24(Seventh) and, as such, may be enforced in proceedings under applicable law.

If you have any questions, please contact Senior Attorney Christopher Manthey in the Bank Activities and Structure Division at (202) 874–5300.

Julie L. Williams
Chief Counsel

855—March 1, 1999

12 USC 24(7)

Dear [ ]:

This is in response to your letter dated February 4, 1999 to Mr. Richard T. Erb, Licensing Manager, Corporate Activities, on behalf of [ ], ("the bank") *[City, State].* You requested confirmation that it would be lawful for the bank to acquire a direct noncontrolling minority investment in [ ], ("*Inc.*") a Delaware corporation, and thereby acquire indirectly, a noncontrolling minority interest in *[Inc.]'s* sole subsidiary, [ ] ("the LLC"), a limited liability company providing stored value systems. You have also requested confirmation that the bank may acquire, retain and exercise options on shares of *[Inc.]* common stock in connection with the proposed investment. Subject to the conditions set forth herein, it is our opinion that the transactions, as described below, are legally permissible.

Background

The bank is a limited purpose credit card bank and a wholly owned subsidiary of [ ] ("*Corp.*"), a registered multibank holding company headquartered in *[City, State]*. The LLC is an existing for-profit Delaware limited liability company owned directly by [ ] *("A1"),* [ ] *("A2"),* [ ], *("A3"),* and a group of officers and managers of the LLC ("the management group"). *([A1, A2, A3],* and the management group collectively referred to as "current LLC owners"). The LLC engages in "smart card" activities and in the development, marketing, delivery and maintenance of stored value and information systems intended for use by system customers and other businesses.[1] The LLC's stored value system enables cardholders to make cashless payments to participating users in a "closed system" with a sponsoring system customer, such as a university and its students, faculty, departments and merchants, or to other merchants outside of a sponsoring system customer. The LLC has been operational for two and one-half years and presently has installed stored value and smart card systems for 14 system customers, including 12 universities, and has agreements to provide such systems to six other entities.

According to your letter, the LLC will be reorganized in the near future so that not less than 98 percent of the membership interests in the LLC presently held by the current LLC owners will be converted into interests in the common stock of *[Inc.]* and *[Inc.]* will become the parent holding company of the LLC. The sole activity of *[Inc.]* will be to hold not less than 98 percent of the membership interest and voting control of the LLC. Following the contemplated reorganization of the LLC, *[A1]* will hold a 2 percent membership interest in the LLC while the other current LLC owners will hold approximately the same percentage ownership interests in the common stock of *[Inc.]* as they presently do in the equity of the LLC.[2] The common stock in *[Inc.]* to be held by the management group will be nonvoting.[3]

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[1] A "smart card" is a plastic card with an embedded integrated circuit that looks like a credit card. A smart card is essentially a mini-computer that can store both data and programs. Depending on the capacity of the integrated circuit, the smart card may hold only limited information, or may have the capability of performing more complex computing functions. For stored value smart cards, an electronic device is used to load (add) or deduct value stored on the computer chip. The plastic card is able to pass information to a card reader that stores such information for later downloading, processing and use.

[2] Currently, *[A1]* holds a 35 percent voting membership interest in the LLC, *[A2]* and *[A3]* each have a 25 percent voting membership interest in the LLC, and the management group holds a 15 percent non-voting membership interest in the LLC.

[3] The first three-quarters of the bank's initial 10 percent ownership interest in *[Inc.]* will reduce, proportionally, the percentage ownership interest of *[A1], [A3]* and *[A2],* but will not reduce the percentage ownership interest of the management group in *[Inc.]*. The last one-fourth of the bank's initial 10 percent ownership interest in *[Inc.],* and any additional shares that the bank might acquire pursuant to the exercise of options on *[Inc.]* common stock, will reduce the interest of all the current LLC owners, including the management group, proportionally.

The bank seeks to acquire a minority ownership interest (between 10 percent and 19.8 percentof the capital stock) in *[Inc.]*. Under the terms of the proposal, the bank would initially acquire 10 percent of the common stock of *[Inc.]* and options for purchasing an additional 9.8 percent of the common stock of *[Inc.]* in consideration of $4 million in cash. The LLC will use these funds for its operations. The option for purchasing the additional 9.8 percent of the common stock of *[Inc.]* may be exercised by the bank at $0.10 per share if certain conditions are met, *i.e.,* the bank successfully causes the LLC to acquire new contracts, primarily with colleges and universities and potentially also with hospitals, business centers, theme parks, and military installations (collectively referred to as "system customers"). The option must be exercised in full by December 31, 2000. If the option is fully exercised, the bank will hold approximately 19.8 percent of *[Inc.]'s* common stock.

Analysis

The bank's proposal to hold up to a 19.8 percent interest in *[Inc.]* raises the issue of the authority of a national bank to make a noncontrolling minority investment in a corporation that provides stored value systems and services through a subsidiary organized as a limited liability company. In a variety of circumstances the OCC has permitted national banks to own, either directly or indirectly through an operating subsidiary, a noncontrolling interest in an enterprise. The enterprise might be a limited partnership, a corporation, or a limited liability company.[4] In various interpretive letters, the OCC has concluded that national banks are legally permitted to make a noncontrolling investment in a limited liability company, provided four criteria or standards are met.[5] These standards, which have been distilled from our previous decisions in the area of permissible noncontrolling investments for national banks and their subsidiaries are:

(1) The activities of the entity or enterprise in which the investment is made must be limited to activities that are part of, or incidental to, the business of banking;

(2) The bank must be able to prevent the entity or enterprise from engaging in activities that do not meet the foregoing standard or be able to withdraw its investment;

(3) The bank's loss exposure must be limited, as a legal and accounting matter, and the bank must not have open-ended liability for the obligations of the enterprise; and

(4) The investment must be convenient or useful to the bank in carrying out its business and not a mere passive investment unrelated to *that bank's* banking business.

Each of these factors is discussed below and applied to your proposal.

1. *The activities of the entity or enterprise in which the investment is made must be limited to activities that are part of, or incidental to, the business of banking.*

Our precedents on noncontrolling stock ownership have recognized that the enterprise in which the bank takes an equity interest must confine its activities to those that are part of, or incidental to, the business of banking.[6] It is well established that a national bank may use electronic or data processing technology to perform services expressly or incidentally authorized to national banks.[7] The OCC previously approved *[A3]'s* acquisition of a minority interest in this LLC after determining that the LLC's activities were part of, or incidental to, the business of banking, and thus, permissible activities for national banks and their subsidiaries.[8] Therefore, this standard is satisfied.

2. The bank must be able to prevent the entity or enterprise from engaging in activities that do not meet the foregoing standard or be able to withdraw its investment.

This is an obvious corollary to the first standard. The activities of the enterprise in which a national bank may invest must be part of, or incidental to, the business of banking not only at the time the bank first acquires its ownership, but for as long as the bank has an ownership interest.

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[4] *See also* 12 CFR 5.36(b). National banks are permitted to make various types of equity investments pursuant to 12 USC 24(Seventh) and other statutes.

[5] *See, e.g.,* OCC Interpretive Letter No. 778 (March 20, 1997), *reprinted in* [1997 TransferBinder] Fed. Banking L. Rep. (CCH) ¶ 81–205 and OCC Interpretive Letter No. 692 (November 1 1995), *reprinted in* [1995–1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,007.

[6] *See, e.g.,* OCC Interpretive Letter No. 380 (December 29, 1986), *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,604 n.8 (since a national bank can provide options clearing services to customers, it can purchase stock in a corporation providing options clearing services); OCC Interpretive Letter No. 694 (December 13, 1995), *reprinted in* [1995–1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 91–009 (national bank permitted to take noncontrolling minority investment in a limited liability company that purchases secured home improvement loans and resells them in the secondary market); OCC Interpretive Letter No. 711, *reprinted in* [1995–1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–026 (February 23, 1996) (national bank may take a minority equity interest in a mortgage banking company).

[7] *See* OCC Interpretive Letter No. 677, *reprinted in* [1994–1995 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,625.

[8] *See* OCC Interpretive Letter No. 737, *reprinted in* [1996–1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,101.

Your letter states that the organizational, membership and operational documents and agreements with respect to *[Inc.]* and the LLC provide adequate means to prevent *[Inc.]* and its subsidiary, the LLC, from engaging in activities not authorized for national banks. Although all of the documents providing for the bank's acquisition of a minority interest in *[Inc.]* have not been finalized, several provisions of these documents submitted to us at our request confirm your representations that this standard is satisfied. Specifically, the Third Article of the Draft Certificate of Incorporation of *[Inc.],* Article 2, Section 2.3 of the Amended and Restated Limited Liability Company Operating Agreement and Article VI, Section 6.2(j) of the Draft Shareholder's Agreement among the current LLC owners and the bank, state that the activities of *[Inc.]* and the LLC must be "permissible for a national banking association". Additionally, these documents require that "all necessary regulatory notices and applications have been given and any necessary consents received prior to engaging in any such activity." Moreover, because these provisions cannot be amended without unanimous shareholder consent, the bank will be able to veto any expansion of activities of *[Inc.]* and the LLC that are impermissible for national banks. Therefore, this standard is satisfied.

3. The bank's loss exposure must be limited, as a legal and accounting matter, and the bank must not have open-ended liability for the obligations of the enterprise.

a. Loss exposure from a legal standpoint

A primary concern of the OCC is that national banks not be subjected to undue risk. Where an investing bank will not control the operations of the entity in which the bank holds an interest, it is important that a national bank's investment not expose it to unlimited liability. Normally, this is not a concern when a national bank invests in a corporation, for shareholders are not liable for the debts of the corporation, provided proper corporate separateness is maintained.[9] In the present case, both *[Inc.]*] and the bank will be separate corporations, with their own capital, directors, and officers.

As a legal matter, the bank's risk of loss will be limited by Delaware law. No member or manager of a Delaware limited liability company is personally liable for any debts, obligations or liability of the limited liability company solely by being a member or acting as a manager of the limited liability company.[10] Therefore, the bank's risk of loss is limited to the amount of its capital investment in the LLC. In addition, under Delaware corporate law, a shareholder as a general rule is not liable or responsible for the debts of a corporation solely because he or she is a shareholder of that corporation. The bank is further insulated from liability by the "corporate veil" under corporate law since its interest in the LLC stems from being a shareholder of the parent corporation, *[Inc.]*.

Thus, the bank's loss exposure for any liabilities of *[Inc.]* and the LLC will be limited.

b. Loss exposure from an accounting standpoint

The bank's investment will be made by cash purchase in the amount of $4 million, although actual exercise of the option requires, in addition to the $0.10 per share exercise price, that certain conditions be met. The bank's accountants have advised that the appropriate treatment for its investment in *[Inc.],* whether it is 10 percent, 19.8 percent, or some percentage between 10 percent and 19.8 percent, is as an unconsolidated investment under the equity method of accounting.[11]

In assessing a bank's loss exposure as an accounting matter, the OCC has previously noted that the appropriate accounting treatment for a bank's 20–50 percent ownership share of investment in a corporation or limited liability company is to report it as an unconsolidated entity under the equity method of accounting. Under this method, unless the bank has guaranteed any of the liabilities of the entity or has other financial obligations to the entity, losses are generally limited to the amount of the investment, including loans and other advances shown on the investors's books.[12] Similarly, under the cost method of accounting (generally used for equity interests of less than 20 percent in a corporation), the investor records an investment at cost, dividends or distributions from the entity are the basis for recognition of earnings, and losses recognized by the investor are limited to the extent of the investment. In sum, regardless of which accounting method is used, the investing bank's potential loss is limited to the amount of the investment.

[9] 1 William M. Fletcher, Fletcher Cyclopedia of the Law of Private Corporations § 25 (perm. ed. rev. vol. 1990).

[10] *See* DEL. CODE ANN. tit. 6 § 18–303 (1998).

[11] The bank's accountants believe that the equity method is appropriate in this case because they anticipate that the bank will exercise its option to purchase additional stock, bringing it very close to a 20 percent ownership interest in *[Inc.]*. Even if the bank were not to exercise the option, under generally accepted accounting principles, the bank will still evidence indicia of its ability to exercise control or influence the operating or financial decisions of the investee, *[Inc.], e.g.,* through shareholder and board representation and the symbiotic relationship between the bank and *[Inc.]* in which each is dependent on the others' efforts in attracting new customer lines and banking products.

[12] *See generally* Accounting Principles Board, Op.18 § 19 (1971) (equity method of accounting for investments in common stock).

As proposed, the bank will have between a 10 percent and 19.8 percent ownership share in *[Inc.],* depending on whether it exercises its option to purchase additional stock. As noted above, Delaware law limits the bank's losses to its capital investment. In addition, the relevant agreements contain provisions that confirm that no investor in the LLC will have liability for the debts, obligations and liabilities of the LLC. Therefore, for both legal and accounting purposes, the bank's potential loss exposure to *[Inc.]* and the LLC should be limited to the amount of its investment. Since that exposure will be quantifiable and controllable, the third standard is satisfied.

4. The investment must be convenient or useful to the bank in carrying out its business and not a mere passive investment unrelated to that bank's banking business.

A national bank's investment in an enterprise or entity that is not an operating subsidiary of the bank must also satisfy the requirement that the investment have a beneficial connection to that bank's banking business, *i.e.,* it must be convenient or useful to the investing bank's business activities and not constitute a mere passive investment unrelated to the bank's banking business. Twelve USC 24(Seventh) gives national banks incidental powers that are "necessary" to carry on the business of banking. "Necessary" has been judicially construed to mean "convenient or useful."[13] Therefore, a consistent concept running through our precedents concerning stock ownership is that it must be convenient or useful to the bank in conducting that bank's banking business. The investment must benefit or facilitate that business and cannot be a mere passive or speculative investment.[14]

The bank's investment in *[Inc.]* will not be a passive investment. The bank anticipates the enhancement of its credit card business and the development of new business opportunities as a result of its ownership interest in *[Inc.].* The bank hopes to serve as the issuing bank for participating system customers and its cardholders. In addition, the bank expects to be actively involved as a shareholder and through anticipated board representation in *[Inc.]'s* activities. The bank's desire to exercise options to purchase additional stock in *[Inc.]* is part of the bank's broader business plan and is further evidence that this is a not a speculative investment. The bank's investment will forge a symbiotic relationship with *[Inc.]* based on mutual dependency whereupon each will derive benefits from the efforts of the other in attracting new system customers and selling bank products. Thus, the fourth standard is satisfied.

Conclusion

Based upon the information and representations you have provided, and for the reasons discussed above, we conclude that *[Bank], [City, State],* may acquire and hold a noncontrolling 19.8 percent interest in *[Inc.],* and thereby acquire, indirectly, a 19.8 percent noncontrolling interest in *[Inc.]'s* sole subsidiary, *[LLC].*[15] Our conclusion is conditioned upon compliance with the commitments made in your letter of inquiry and with the conditions listed below:

(1) [ ] *("Inc.")* and [ ] ("the LLC") may engage only in activities that are part of, or incidental to, the business of banking;

(2) The bank will have veto power over any activities and major decisions of *[Inc.]* and the LLC that are inconsistent with condition number one or the bank will withdraw its investment from *[Inc.]* and the LLC if either proposes to engage in any activity that is inconsistent with condition number one;

(3) The bank will account for its investment in the LLC as an unconsolidated entity under the equity or cost method of accounting; and

(4) *[Inc.]* and the LLC will be subject to OCC supervision, regulation, and examination.

These commitments and conditions are conditions imposed in writing by the OCC in connection with its action on the request for a legal opinion confirming that the proposed investment is permissible under 12 USC 24(Seventh) and, as such, may be enforced in proceedings under applicable law.

I hope that this has been responsive to your inquiry. If you have any questions, please contact Susan L. Blankenheimer, Senior Attorney, Bank Activities and Structure Division at (202) 874–5326.

Julie L. Williams
Chief Counsel

[13] *Arnold Tours Inc.* v. *Camp*, 472 F.2d 427, 432 (1st Cir. 1972).

[14] *See e.g.,* OCC Interpretive Letter No. 543, *reprinted in* [1990–1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,225 (February 13, 1991) (national bank authorized to acquire nominal stockholding for membership in corporation of primary dealers in government securities); OCC Interpretive Letter No. 427, *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,651 (May 9, 1988) (national bank permitted to buy Farmer Mac stock in nominal amounts); OCC Interpretive Letter No. 421, *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,645 (March 14, 1988) (national bank permitted to invest in the Government Securities Clearing Corporation).

[15] Since the bank has satisfied the four part test for minority investments, it may make the initial 10 percent investment in these entities as well as exercise the option for up to an additional 9.8 percent investment, for a total combined investment of 19.8 percent.

856—March 5, 1999

12 USC 24(7)

William W. Templeton
Senior Counsel
Legal Department
Fleet Financial Group
50 Kennedy Plaza
Providence, RI 02903

Dear Mr. Templeton:

This responds to your request for an opinion on whether a national bank may offer certain connected Internet services and payments services to its small business banking customers pursuant to the authority in 12 USC 24(Seventh) of the National Bank Act. Specifically, Fleet National Bank (the "bank") wishes to offer a package of services that will include enabling its small business banking customers ("retailers") to establish a retail sales presence on the Internet. Based upon the information and representations provided, I conclude that the proposed activity, as described in detail below, is permissible for a national bank.

Background

The bank proposes to offer its small business customers a package of electronic services (hereafter referred to as the "product") that bundles traditional merchant credit card banking services with the software, hardware and technical support necessary for a small business to have its own retail Web site that is able to accept credit card payments in a secure environment.[1] The package also includes monthly reports relating to activity on a retailer's Web site.

To purchase the product, a retailer must: (i) already be, or qualify to be, a credit card merchant customer of the bank, and (ii) have, or establish, a business checking account with the bank. The bank will provide authorization and processing services for credit card payments received through a retailer's Web site and will deposit the proceeds in the retailer's checking account with the bank. In exchange for a one-time set up fee,[2] a retailer is assigned a unique Internet Web site address,[3] which the bank registers with the major Internet search engines. The Web site address can either include or not a reference to the bank's URL, (e.g., "http://www.bank.com/yourbusinessname" or http://www.yourbusinessname) depending upon the retailer's choice.[4]

The retailer's Web site resides on Internet servers that are controlled by the bank but not connected to any of the bank's mainframe accounting or internal systems processing servers. The retailer also is given access to the Web site's "storebuilder wizard"—a menu-driven software that enables the retailer to build a catalog of product descriptions, pricing, delivery information and order forms. The retailer works independently to build the Web site to its satisfaction subject only to the limitation that the site cannot list more than 500 products. The product database (representing the retailer's online catalog) is maintained and stored on the bank's server.

Once the retailer has established a business checking account, obtained credit underwriting approval to be a credit card merchant customer, and completed construction of the Web site, the site is activated so that potential retail customers can access the site. After activation, the

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[1] A retail enabled Web site will be able to accept credit card purchases on-line. This service will allow retailers to create and maintain a Web site that can also use the bank's secure payments service. Bank is currently offering a Web site credit card enabling service as a stand-alone service to retailers with Web sites either established or in development. This particular product offering has, thus far, generally been directed at larger companies with their own established Web sites.

[2] Bank will charge a one time set up fee and a monthly maintenance fee for the product. The Web site product (with related system support) is not available as a separate product offering and cannot be purchased without the entire package of associated banking products and services, such as the checking account and merchant credit card relationship. Although the product will generate revenues from several sources, the bank expects that the revenues from the associated traditional bank products will greatly exceed those relating only to the Web site services.

[3] This address will be a Universal Resource Locator ("URL").

[4] The use of part of the bank's name in the retailer's URL could under some circumstances create a risk that the public will identify the bank with the Web site of its retailer customers. However, that risk is mitigated here by the bank's commitment to take all appropriate measures to limit its reputation risk associated with the retailer's Web site. Once activated, the retailer's Web site "store" will not carry any indication that it is carried on the bank's servers or supported by bank, aside from the URL that may be used by some retailers (and the concomitant URL registration information that is publicly available). No bank logo or any other reference to the bank will appear within a retailer's Web site store, except as may be necessary to effect the payments processing component. Bank will also limit its reputation risk by reserving the right to prohibit offensive or indecent material from hosted sites.

This retail Web hosting activity does not carry the same risks of bank customer confusion that can arise when a bank links *its* retail Web site to sites of third parties so that bank customers are transported from a bank site to a nonbank site*, e.g.,* a bank-sponsored "virtual or Internet mall." *Compare,* OCC Conditional Approval No. 221, *supra*. However, these risks could arise if the bank began to link its retail banking Web site to the retailer sites it hosts. Bank has not indicated any intention to do this and, thus, we do not address it here.

bank provides ongoing maintenance and support of the Web site's host servers and monthly reports on empirical data such as site "hits" and transaction volume.

The bank servers maintain all the data associated with the Web site, including product descriptions, images, and pricing.[5] The bank also provides functions[6] by which customers of a retailer select products, communicate their selection to the retailer, and pay for products. Payments are made through a credit card, for which the bank provides the payment authorization and processing.[7]

The bank's retail Web site hosting service also, via the Internet, provides an electronic communications pathway between the retailer and its potential customers through which product orders and payment information flow. When a visitor to a retailer's site submits a potential purchase order, the bank captures and processes the necessary payments-related information and forwards an electronic message to the retailer with the associated product and shipping order information. The retailer is also able to electronically confirm payment authorization before shipping any goods.[8] Payment proceeds are deposited into the retailer's business checking account with the bank.

To maintain the site, the retailer pays the bank a monthly maintenance fee for the Web site. In addition, all credit card purchases made through the site are assessed a credit card processing fee as a percentage of the amount, called a "merchant discount." The business checking account carries a fee as well. The retailers will be cross-marketed other bank products and banking services tailored to small business in an attempt to win other aspects of their retail banking business.

OCC recognizes that the proposed activity exposes the bank to risks associated with accepting retail credit card payments on the Internet and conducting the activities necessary to clear and settle the payments received. The risks associated with credit underwriting, payment authorization, and processing are the same risks that banks already assume when providing merchant credit card processing services for business customers.[9] The risks associated with accepting and authorizing payments through the retailer's Web site are identical to those already assumed when the bank enables an established Web site to receive credit card orders. These risks include maintaining the accessibility, integrity, and confidentiality of the information systems necessary to complete the retail transactions through the Web site.[10] To the extent that the bank contracts with other service providers, notably technology firms, to provide any of the necessary products and services to offer the product to small business customers, the bank will manage its indirect risk exposure to the activities of the service providers. Accordingly, the bank has the necessary skills and expertise to effectively manage the risks.

Discussion

The product offered by the bank to retailers has three component services: retail Web site hosting, retail payments processing, and business checking accounts. As each of these components is part of the business of banking, the

[5] Each retailer is responsible to maintain and update the store and product information contained on their Web site.

[6] The ordering function is a Web page that lists all products selected by the visitor to the site. The paying function page allows the visitor to enter their credit card number, address, and shipping location in association with their potential purchase. These functions are applications that provide temporary storage of information relating to items selected for purchase as well as necessary payment and shipping information. Upon purchase authorization by the visitor, the application requests credit authorization and provides notification to the buyer and retailer when authorization is received so the purchase may be completed if the parties elect to do so.

[7] Traditional merchant banking services are those services that enable retailers to collect the funds from credit card payments for goods and services sold. Once a retailer is approved through the credit underwriting process, the merchant bank provides the retailer with a card-accepting device for authorizing and recording credit card transactions. The merchant bank then provides services to clear and settle the credit card payments to the retailer, depositing funds collected in the retailer's account.

[8] The bank also provides sales tax calculations for the retailer using information on the product sold, the merchandise receiving location, and the identified state in which the retailer operates. When constructing their Web sites, the retailers are responsible to identify the product codes and to identify their state of operation. In their agreement with the bank, the retailers acknowledge that they are responsible for the accuracy, collection, and submission of all appropriate and applicable sales taxes.

[9] As with other merchant credit card customers, applicants for the proposed product will be subject to a credit underwriting review by the bank's merchant credit card division.

[10] Through an addendum to its merchant credit card agreement with its customers, the bank will limit its legal liability for security breaches and systems failures.

product is part of the business of banking and, thus, permissible for national banks under 12 USC 24(Seventh).[11]

Retail Web site hosting, as proposed by the bank, is a form of finder activity authorized for national banks. The OCC has long recognized the finder function as a permissible banking activity that includes, "without limitation, identifying potential parties, making inquiries as to interest, introducing or arranging meetings of interested of parties, and otherwise bringing parties together for transactions that the parties themselves negotiate and consummate." 61 Fed. Reg. 4863 (February 9, 1996) (codified at 12 CFR 7.1002(b)).[12] Finder activities are part of the business of banking. OCC Interpretive Letter No. 824, *reprinted in* [1997-1998 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-273 (February 27, 1998); OCC Corporate Decision No. 97-60 (July 1, 1997); and OCC Conditional Approval Letter No. 221, *supra*.[13]

The OCC has also recognized that banks may use new technology to conduct the finder activity. We have said:

> The means that national banks use to act as finders for their customers have evolved due to technological advancements. Where banks once performed this service for their customers via newsletters and personal contacts, they presently conduct the activity with computer technology.

Id. See also, OCC Interpretive Letter No. 516, *reprinted in* [1990-1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,220 (July 12, 1990) (national banks may provide electronic communications channels for persons participating in securities transactions) and Letter from Julie L. Williams, Chief Counsel, October 2, 1996 (unpublished) (national bank as finder could use electronic means to facilitate contacts between third party providers and potential buyers).

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[11] Assuming arguendo that the retail Web hosting service was not part of the business of banking, an alternative grounds for permitting the activity would be that the bank's Web hosting activity is incidental to two traditional banking services: merchant credit card processing and business checking account services. The bank has provided information indicating that provision of the Web hosting service will significantly enhance the utility and desirability of these established banking services to the bank's retail merchant customers and to allow the bank to meet competition from non-banking firms that provide a similar package of services. See, e.g., OCC Conditional Approval No. 221, supra, and OCC Interpretive Letter No. 742, supra, (national banks providing home banking services via the Internet may also provide Internet access service to the banking customers as a product incidental to Internet home banking). Further, information provided by the bank establishes that the anticipated level of revenue from the bank's retail Web site hosting component relative to the revenue from the associated business deposit account and merchant processing services would likely meet the subordination requirement for non-banking services incidental to banking services. OCC has said an incidental product may not dominate its connected banking service, but that where the gross profits generated by an incidental product provided in a package with a banking service do not exceed 30 percent of the total gross profits from the entire service package, the sale of the incidental product meets the subordination requirement. OCC Conditional Approval No. 221, (December 4, 1996); OCC Interpretive Letter No. 754, *reprinted in* [1996-1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,118 (November 6, 1996) (national bank operating subsidiary may sell general purpose computer hardware to other financial institutions as part of larger product or service when necessary, convenient, and useful to bank permissible activities). However, it is unnecessary to address that issue here because we conclude that the bank's Web site hosting activity is part of, rather than incidental to, the business of banking, and thus is not subject to scope limitations that apply to some incidental activities.

[12] 12 CFR 7.1002 provides in its entirety:

> (a) General. A national bank may act as a finder in bringing together a buyer and seller.
>
> (b) Qualification. Acting as a finder includes, without limitation, identifying potential parties, making inquiries as to interest, introducing or arranging meetings of interested parties, and otherwise bringing parties together for transactions that they themselves negotiate and consummate. Acting as a finder does not include activities that would characterize the bank as a broker under applicable federal law.
>
> (c) Advertisement and fee. Unless otherwise prohibited, a national bank may advertise the availability of, and accept a fee for, the services provided pursuant to this section.

Earlier OCC decisions regarding finder activities cite 12 CFR 7.7200. OCC interpretive rulings at 12 CFR Part 7 were revised and renumbered effective April 1, 1996. Interpretive ruling § 7.1002 (1996) replaced former interpretive ruling § 7.7200. The bank has committed that its finder activities will be conducted in accordance with the provisions of 12 CFR 7.1002.

[13] See also, Letter from J.T. Watson, Deputy Comptroller of the Currency, February 26, 1969 (unpublished); Letter from John M. Miller, July 26, 1977 (unpublished); Letter from Paul Allan Schott, Chief Counsel, May 9, 1988 (unpublished); Letter from Elizabeth Corey, May 18, 1989 (unpublished); OCC Interpretive Letter No. 238, *reprinted in* [1983-1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,402 (February 9, 1982); OCC Interpretive Letter No. 472, *reprinted in* [1989-1990 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,008 (March 2 1989); Letter from Lee Walzer, Attorney, Securities, Investments and Fiduciary Practices Division, August 24, 1992 (unpublished); and OCC Interpretive Letter No. 741, *reprinted in* [1996-1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-105 (August 19, 1996); and OCC Conditional Approval No. 220 (October 2, 1996). Cf. *Norwest Bank* v. *Sween Corp.*, 118 F.3d 1255 (8th Cir. 1997).

Clearly, one of the product's most significant functions for the retailers is to provide potential customers, via the Internet, with information about the retailers' goods and services. The OCC has concluded that "[p]roviding information [to prospective buyers about the products or services of prospective sellers] is one of the fundamental activities of a finder," and that as part of the finder function national banks may "make inquiries as to interest, arrange a meeting of the interested parties, and provide information pertinent to the meeting of the buyer and seller." OCC Interpretive Letter No. 653, *reprinted in* [1994-1995 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,601 (December 22, 1994). The function of finder involves the "conveying of information about available products or services to potential markets for them . . . ." OCC Interpretive Letter No. 741, *supra*. *See also,* OCC Corporate Decision 98-13 (February 9, 1998) (national bank finder, as a benefits counselor, could provide potential buyers with information on benefits programs available); OCC Interpretive Letter No. 824, *supra*, (banks participating in a finder program would provide brochures, leaflets, and other literature informing customers on the availability of products and services from the potential seller); OCC Interpretive Letter No. 630, *reprinted in* [1993-1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,513 (May 11, 1993) (finder banks may distribute informational brochures); OCC Interpretive Letter No. 593, *reprinted in* [1992-1993 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,418 (July 1, 1992) (finder banks providing information on third party brokerage services); and Letter from Julie L. Williams, Chief Counsel, October 2, 1996 (unpublished) (national bank as part of finder function could provide marketing materials and information about third party service providers to potential buyers).

Maintaining or providing an Internet Web site for retailers is one device that national banks may use as finders to provide or make available information to potential buyers. Thus, in Corporate Decision 97-60, *supra*, the OCC found that a national bank conducting finder activities to support sales of pre-owned automobiles could maintain and operate an Internet Web site which provided information to potential buyers on the vehicles offered.[14]

It also follows that to perform its finder function of providing information, a national bank must store and retrieve the information to be provided. Thus, in OCC Interpretive Letter No. 741, *supra*, the OCC found that under the finder authority, a national bank could operate a call center facility which provided access to bank-maintained database on new or used vehicles offered for sale. A similar finding is also implicit in OCC Corporate Decision No. 97-60, *supra*. Thus, it is permissible for the bank, when hosting an Internet Web site as a finder, to store and retrieve electronically on its servers the data set for the retailer's on-line catalog as part of the finder function.

There is no need to analyze whether the data set storage and retrieval functions in this case are "incidental" to the permissible finder activity because, for the reasons discussed, the data functions are actually part of the finder service, not a separate product or service. The OCC has distinguished incidental products, which support business of banking activities, from products like the data set functions here that, although arguably distinct from a related banking product, really are so closely connected to the banking product that the banking product cannot be provided without it. In other words, the other product is effectively merged with and becomes part of the banking product and, hence, becomes itself part of the business of banking. OCC has said:

> In analyzing the extent to which national banks may provide hardware and software, the OCC has distinguished between general purpose items, which can be used for purposes beyond banking services, and limited purpose items, which can be used solely for banking services. Limited purpose hardware is considered an indistinguishable part of banking services and, thus, part of the business of banking.

OCC Interpretive Letter No. 754, *supra*. *See also* OCC Interpretive Letter No. 737, *reprinted in* (1996-1997 Transfer Binder) Fed. Banking L. Rep. (CCH) ¶ 81,101 (August 19, 1996)(where a national bank was providing a closed stored value system to an institutional customer, the bank could as part of that service also provide system participants with certain hardware and software to be used for the stored value functions; the equipment was not viewed as a separate product or service) and OCC Interpretive Letter No. 345, *reprinted in*, [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,515 (July 9, 1986).[15]

Another significant finder function is to bring together potential buyers and sellers. The OCC has found that one approach to this communication function is for the finder bank to provide an electronic medium to support communications between potential buyers and sellers so they can arrange their transactions. Thus, in OCC Conditional

[14] Accordingly, we also find that the bank may, as part of its finder service, register a retailer's Web site with search engines. This is merely an additional device to serve the finder function of making information available to potential buyers.

[15] The OCC said:

> When the hardware is such that it is not to be used for uses beyond the [bank services], it may well be considered literally an indistinguishable part of the [banking services]. Accordingly, a national bank's sale of such hardware is permissible as a part of the [service] permitted under 12 USC 24(Seventh), just as the bank's sale of checkbooks to its customers is a permissible part of offering checking accounts.

Approval No. 221, *supra*, the OCC found that, as part of the finder function, a national bank could provide hypertext links between the bank's retail banking Web site and the Web sites of third parties interested in selling products or services to the bank's customers. We said: "By providing links to third party vendors' Web sites, the [LLC] merely introduces two parties who then engage in a transaction." *See also*, OCC Interpretive Letter No. 611, *reprinted in* [1992-1993 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,449 (November 23, 1992) (national bank linking non-bank service providers to its communications platform of smart phone banking services was within its authority as a finder "in bringing together a buyer and seller") and Letter from Julie L. Williams, Chief Counsel, October 2, 1996 (unpublished). For this reason, the bank may communicate to its retailers the offers to buy that result from their bank hosted Web sites as part of its product.

Finally, by hosting the Web site, the bank does not become involved in the negotiations of the parties and thereby exceed its proper role as finder*, i.e.,* merely bringing parties together for a transaction that the parties themselves negotiate and consummate. The courts are likely to view retail Web sites as inviting potential buyers to make an offer to the seller to buy the goods advertised on the site. Thus, in this case, the retailers would retain the ability to reject a potential Internet buyer's offer of any potential purchases that might arise from the Web site hosted by the bank. *See, generally*, W. A. Effross, "The Legal Architecture of Virtual Stores: World Wide Web Sites and the Uniform Commercial Code," 34 *San Diego L. Rev.* 1263 (1997) at 1329-1331.

Accordingly, the retail Web site hosting component to the bank's product is part of the business of banking and, thus, permissible for national banks. We now turn to several other aspects of the product.

As noted, the bank will provide retailers with access to software that will enable the retailers to design their Web sites and software that enables the retailer to build a catalog of product descriptions, pricing, delivery information and order forms. This is permissible. OCC has found a national bank can provide access to software that will enable bank customers to use or receive electronic banking services from the bank such as a specialized payment service or informational services. The software is "necessary" to use or fully enjoy the permissible service and, thus, is either part of the service (if limited function) or incidental thereto (if full function). Thus, in Conditional Approval No. 221, *supra*, the OCC found that providing full-function Web browser software is a permissible incidental activity when a national bank is offering a home banking system based on Web server technology using "Internet compatible" browser software. The fact that the customer might use the browser software for other non-banking purposes did not preclude the sale.[16]

The bank will also process payments resulting from orders received from a retailer's Web site. Clearly, payments processing and handling of accounts receivable is part of the business of banking. OCC Conditional Approval No. 289 (October 2, 1998) (national banks may acquire a minority interest in a firm that, among other things, provides accounts receivable processing and accounts payable processing); OCC Conditional Approval No. 282 (July 7, 1998) (national bank may acquire an interest in a firm that would, among other things, engage in payments processing for the health care firms); and OCC Interpretive Letter No. 731, *reprinted in* [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,048 (July 1, 1996) (national banks as part of the banking business may collect and process accounts in relating to an electronic toll collection system).

The bank will provide its retailers with monthly reports on empirical data such as site "hits" and transaction volume arising from their Web sites, including number and types of products sold. To the extent that these reports involve the processing and transmittal of information relating to specific payment transactions the bank handles for the retailer, it is part of the payment processing function and not a separate service.[17] OCC Interpretive Letter No, 731, *supra* and OCC Interpretive Letter No. 732, *reprinted in* [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,049 (May 10, 1996) (design, development, marketing, and maintenance of a network for electronic funds transfer and electronic data interchange permissible for a national bank). Cf. Letter from Julie L. Williams, Chief Counsel, October 2, 1996 (unpublished) (national bank acting as finder could maintain a database of transactions resulting from its finder activities was "integral" to the finder function).

As for the more general information and reports, the OCC has long held that as part of the business of banking, national banks may collect, transcribe, process, analyze, and store for itself and others banking, financial, or related

[16] *See also*, OCC Interpretive Letter No. 516, *supra* (national bank that is providing customers with a permissible database service of information relating to financial instruments can also provide software that enables the customers to download and analyze the information) and OCC Interpretive Letter No. 419, *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,463 (February 2, 1988) (national bank that is providing customers with a permissible electronic transactional and information service can provide software that enables customers to participate in the system).

[17] Under its agreements with its retailers, the bank will have an obligation to maintain the confidentiality of the transaction specific data, e.g., that relating to specific purchases by customers of a retailer, that the bank will acquire by offering the package.

economic related data. The general reports will involve the processing of banking, financial, or related economic data and, thus, are part of the business of banking.

An earlier version of 12 CFR 7.1019 stated that "as part of its banking business and incidental thereto, a national bank may collect, transcribe, process, analyze, and store for itself and others, banking, financial, or related economic data."[18] Although in its 1984 revision of the ruling, the OCC deleted this statement because it believed that "specific examples [of permissible electronic activities] are inappropriate given the imprecision of terms and rapid pace of change in the data processing industry, the "analytical framework" embodied in the ruling remained the same.[19] There was no intent to narrow or restrict the substantive effect of the rule.[20]

Thus, OCC has concluded that national banks may keep financial and other records of its customer's sales and disbursements arising from finder banking services provided by the bank. *See* OCC Interpretive Letter No. 653, *supra* (national bank acting as a finder for insurance could also keep financial and other records relating to the client agency sales, receipts and disbursements). *See also,* OCC Interpretive Letter No. 741, *supra* (national bank acting as finder for automobile dealers may also maintain a comprehensive system that allows dealers to track information on customers referred and to generate market statistics such as buying trends and cycles).[21]

Finally, as part of the product, the bank will calculate the sales taxes owed by its retailers on their Internet sales. This activity is incidental to the retail Web hosting and payments processing services and is thus permissible. In *Clement Nat'l. Bank*,[22] the Supreme Court held that a national bank, incidental to its deposit services, could compute, report, and pay the state tax levied upon the interest earned by bank customers on their deposits.

Conclusion

Based upon the foregoing facts and analysis, and the representations made by the bank in connection with its request, I conclude that the proposed activity is permissible for a national bank.

Julie L. Williams
Chief Counsel

[18] Interpretive Ruling 7.3500, 39 Fed. Reg. 14195 (April 22, 1974).

[19] 49 Fed. Reg. 11157 (March 26, 1984).

[20] OCC Interpretive Letter No. 677, *reprinted in*, [1994-1995 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,625 (June 28, 1995). *See also*, OCC Interpretive Letter No. 737, *supra* (national bank may provide transaction and information processing services to support an electronic stored value system); OCC Interpretive Letter No. 653, *supra* (national bank may act as an informational and payments interface between insurance underwriters and general insurance agents); and OCC Interpretive Letter No. 346, *reprinted in* (1985-1987 Transfer Binder) Fed. Banking L. Rep. (CCH) ¶ 85,516 (July 31, 1985) (national banks may maintain records on commodities transactions).

Case authority strongly supports the OCC precedent. In *Ass'n of Data Processing* v. *Board of Governors*, 745 F.2d 677 (D.C. Cir. 1984), the D.C. Circuit Court of Appeals upheld a Federal Reserve Board finding that data processing and database services were closely related to banking (and thus a proper activity for bank holding companies) if the "data to be processed . . . are financial, banking or economic. . . ." In reaching this conclusion the court said: "The record of this proceeding amply demonstrates, if any demonstration is needed, that banks regularly develop and process for their customers large amounts of banking, financial and economic data, and that they do so (and will presumably continue to do so) through the most advanced technological means." 745 F.2d at 689. Moreover, the court indicated that "economic data" would include: "agricultural matters, retail sales matters, housing matters, corporate profits matters, and anything of value in banking and financial decisions." 745 F.2d at 691.

[21] In *National Retailers Corp.* v. *Valley Nat'l. Bank*, 411 F. Supp. 308 (D. Ariz 1976), *aff'd*, 604 F.2d 32 (9th Cir. 1979), a national bank was held not to have the authority to offer a data processing service to retailers involving the collection and compilation of information relating to their retail sales that had been collected by a special cash register. The district court held that no express provision of the National Bank Act authorized national banks to publicly market a retail information service ("RIS") and concluded that, since the RIS was not within the enumerated powers, the determining issue was whether the RIS was within the bank's "incidental powers." 411 F. Supp. at 313. Thus, by implication, the court held that the "business of banking" includes only the enumerated powers. This position has since been superceded by the Supreme Court's ruling in *NationsBank* v. *Variable Life Annuity Co.*, 513 U.S. 251 (1995), that the "business of banking" is not limited to the enumerated powers. The *National Retailers* court failed to consider that non-enumerated informational services can come within the "business of banking" and specifically that the processing of banking, financial and related economic data is part of the business of banking. Ass'n. of Data Processing, supra. In light of these defects, the holding of *National Retailers* is not entitled to much weight. Moreover, it is distinguishable from the bank's proposed retail data reporting services that are to be offered in connection with its finder services which, for the reasons discussed above, are clearly part of the business of banking.

[22] *Clement Nat'l. Bank* v. *Vermont*, 231 U.S. 120 (1913).

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Affiliated mergers (mergers consummated involving affiliated operating banks) 130

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Mergers—January 1 to March 31, 1999

Most transactions in this section do not have accompanying decisions. In those cases, the OCC reviewed the competitive effects of the proposals by using its standard procedures for determining whether the transaction has minimal or no adverse competitive effects. The OCC found the proposals satisfied its criteria for transactions that clearly had no or minimal adverse competitive effects. In addition, the Attorney General either filed no report on the proposed transaction or found that the proposal would not have a significantly adverse effect on competition.

Nonaffiliated mergers (mergers consummated involving two or more nonaffiliated operating banks), from January 1 to March 31, 1999

Title and location (charter number)	Total assets
Alabama	
SouthTrust Bank, National Association, Birmingham (014569)	35,451,823,000
and Langham Creek National Bank, Houston (018402)	136,000,000
merged on March 12, 1999 under the title of SouthTrust Bank, National Association, Birmingham (014569)	35,603,438,000
Delaware	
MBNA America Bank, National Association, Wilmington (022381)	21,632,664,000
and PNC National Bank, Wilmington (023227)	4,051,838,000
merged on March 29, 1999 under the title of MBNA America Bank, National Association, Wilmington (022381)	24,501,166,000
Missouri	
The Boone County National Bank of Columbia, Columbia (001770)	645,262,000
and Sturgeon State Bank, Sturgeon	37,642,000
merged on February 16, 1999 under the title of The Boone County National Bank of Columbia, Columbia (001770)	685,697,000
Nebraska	
Enterprise Bank, National Association, Omaha (022233)	77,230,000
and The First National Bank of Akron, Akron (018175)	12,385,000
merged on March 19, 1999 under the title of Enterprise Bank, National Association, Omaha (022233)	88,823,000
Pennsylvania	
National Penn Bank, Boyertown (002137)	1,670,809,000
and The Elverson National Bank, Elverson (010775)	301,814,000
merged on January 4, 1999 under the title of National Penn Bank, Boyertown (002137)	1,972,623,000
Chase Manhattan Trust Company, National Association, Pittsburgh (023548)	109,831,000
and PNC Trust Company Pennsylvania, National Association, Pittsburgh (023762)	1,000
merged on December 1, 1998 under the title of Chase Manhattan Trust Company, National Association, Pittsburgh (023548)	220,515,000
Tennessee	
First Farmers & Merchants National Bank of Columbia, Columbia (014710)	562,984,000
and Farmers & Merchants Bank, White Bluff	21,167,000
merged on February 5, 1999 under the title of First Farmers & Merchants National Bank of Columbia, Columbia (014710)	584,151,000
Texas	
The City National Bank of Sulphur Springs, Sulphur Springs (003989)	119,358,000
and The First National Bank of Sulphur Springs, Sulphur Springs (016832)	25,631,000
merged on December 31, 1998 under the title of The City National Bank of Sulphur Springs, Sulphur Springs (003989)	145,000,000
Hibernia National Bank of Texas, Texarkana (003785)	997,493,000
and First Service Bank, Marshall	322,291,000
merged on March 8, 1999 under the title of Hibernia National Bank of Texas, Texarkana (003785)	1,319,784,000

Affiliated mergers (mergers consummated involving affiliated operating banks), from January 1 to March 31, 1999

Title and location (charter number)	Total assets
Alabama	
National Bank of Commerce, Tuscaloosa (022907)	95,000,000
and National Bank of the South, Tuscaloosa (022777)	36,026,000
merged on December 31, 1998 under the title of National Bank of Commerce, Tuscaloosa (022907)	128,026,000
Arkansas	
The Malvern National Bank, Malvern (023202)	202,295,000
and First National Bank of Sheridan, Sheridan (023200)	33,702,000
merged on October 1, 1998 under the title of The Malvern National Bank, Malvern (023202)	235,997,000
California	
First Coastal Bank, National Association, El Segundo (018454)	76,704,000
and American Independent Bank, National Association, Gardena (018092)	38,275,000
merged on March 8, 1999 under the title of First Coastal Bank, National Association, El Segundo (018454)	114,979,000
Georgia	
Georgia First Bank, National Association, Gainesville (023837)	84,630,000
and Gwinett National Bank, Duluth (021839)	36,361,000
merged on February 12, 1999 under the title of Georgia First Bank, National Association, Gainesville (023837)	120,991,000
The First National Bank & Trust Company, Tennille (006207)	108,780,000
and Bank of Wadley, Wadley	22,621,000
and Ogeechee Valley Bank, Millen	24,260,000
merged on March 1, 1999 under the title of The First National Bank & Trust Company, Louisville (006207)	148,780,000
Illinois	
The Old Second National Bank of Aurora, Aurora (004596)	532,425,000
and The Old Second Community Bank of North Aurora, North Aurora	59,822,000
and The Old Second Community Bank of Aurora, Aurora	45,132,000
merged on December 31, 1998 under the title of The Old Second National Bank of Aurora, Aurora (004596)	637,364,000
The Merchants National Bank of Aurora, Aurora (003854)	715,956,000
and Fox Valley Bank, St. Charles	81,011,000
and Hinckley State Bank, Hinckley	64,080,000
merged on December 14, 1998 under the title of The Merchants National Bank of Aurora, Aurora (003854)	861,047,000
Buena Vista National Bank of Chester, Chester (014479)	78,381,000
and Bank of Evansville, Evansville	8,110,000
merged on January 1, 1999 under the title of Buena Vista National Bank of Chester, Chester (014479)	86,491,000
Louisiana	
Hibernia National Bank, New Orleans (013688)	12,514,236,000
and Hibernia National Bank of Texas, Texarkana (003785)	1,005,839,000
merged on January 1, 1999 under the title of Hibernia National Bank, New Orleans (013688)	13,193,393,000
Minnesota	
Norwest Bank Minnesota South, National Association, Rochester (002088)	2,227,810,000
and First National Bank of Monticello, Monticello (018366)	83,891,000
merged on March 6, 1999 under the title of Norwest Bank Minnesota South, National Association, Rochester (02088)	2,311,701,000
U.S. Bank, National Association, Minneapolis (013405)	67,509,000,000
and Zapp National Bank of St. Cloud, St. Cloud (014805)	318,000,000
and The First National Bank of Little Falls, Little Falls (004034)	68,000,000
and Melrose State Bank, Melrose	59,000,000
merged on March 13, 1999 under the title of U.S. Bank, National Association, Minneapolis (013405)	67,926,000,000

Affiliated mergers (continued)

Title and location (charter number)	Total assets
Mississippi	
National Bank of Commerce, Starkville (003656)	563,355,000
and National Bank of Commerce, Tuscaloosa (022907)	128,026,000
merged on December 31, 1998 under the title of National Bank of Commerce, Starkville (003656)	691,381,000
National Bank of Commerce, Starkville (003656)	691,381,000
and The First National Bank of West Point, West Point (002891)	83,362,000
merged on December 31, 1998 under the title of National Bank of Commerce, Starkville (003656)	774,743,000
Missouri	
Mercantile Trust Company, National Association, St. Louis (022666)	44,064,000
and Pennyrile Citizens Bank and Trust Company, Hopkinsville	738,000
merged on February 19, 1999 under the title of Mercantile Trust Company, National Association, St. Louis (022666)	44,802,000
New Jersey	
Commerce Bank/Shore, National Association, Forked River (021863)	454,758,000
and Tinton Falls State Bank, Tinton Falls	186,730,000
merged on January 15, 1999 under the title of Commerce Bank/Shore, National Association, Forked River (021863)	641,488,000
New Mexico	
Norwest Bank New Mexico, National Association, Albuquerque (006187)	2,457,340,000
and First Bank of Grants, National Association, Grants (023652)	41,317,000
merged on February 20, 1999 under the title of Norwest Bank New Mexico, National Association, Albuquerque (006187)	2,498,657,000
Ohio	
Mid American National Bank and Trust Company, Toledo (015416)	989,366,000
and Adrian State Bank, Adrian	175,391,000
merged on January 22, 1999 under the title of Mid American National Bank and Trust Company, Toledo (015416)	1,164,757,000
Mid American National Bank and Trust Company, Toledo (015416)	989,366,000
and First National Bank Northwest Ohio, Bryan (013899)	539,633,000
merged on January 22, 1999 under the title of Mid American National Bank and Trust Company, Toledo (015416)	1,528,999,000
The Huntington National Bank, Columbus (007745)	28,037,904,000
and The Huntington State Bank, Alexandria	138,054,000
merged on January 29, 1999 under the title of The Huntington National Bank, Columbus (007745)	28,175,958,000
Pennsylvania	
First Western Bank, National Association, New Castle (000562)	1,949,179,000
and First Western Services Company, New Castle	2,887,000
merged on September 11, 1998 under the title of First Western Bank, National Association, New Castle (000562)	1,952,066,000
The Citizens National Bank of Lansford, Lansford (007051)	175,522,000
and The Citizens National Bank of Slatington, Slatington (006051)	75,197,000
merged on January 22, 1999 under the title of The Citizens National Bank, Lansford (007051)	250,553,000
Keystone Financial Bank, National Association, Harrisburg (001663)	1,082,281,000
and Financial Trust Company, Carlisle	1,205,324,000
and Keystone National Bank, Lancaster (023176)	115,490,000
and Mid-State Bank and Trust Company, Altoona	1,290,580,000
and Northern Central Bank, Williamsport	1,153,973,000
and American Trust Bank, National Association, Cumberland (023045)	933,884,000
merged on December 31, 1998 under the title of Keystone Financial Bank, National Association, Harrisburg (001663)	5,781,532,000

Affiliated mergers (continued)

Title and location (charter number)	Total assets
Keystone Financial Bank, National Association, Harrisburg (001663)	5,781,532,000
and Keystone Bank, National Association, Horsham (020221)	1,051,363,000
merged on December 31, 1998 under the title of Keystone Financial Bank, National Association, Harrisburg (001663)	6,832,895,000
Tennessee	
National Bank of Commerce, Memphis (013681)	3,839,615,000
and Nashville Bank of Commerce, Nashville	602,942,000
merged on March 1, 1999 under the title of National Bank of Commerce, Memphis (013681)	4,442,557,000
Union Planters Bank, National Association, Memphis (013349)	19,815,274,000
and Merchants Bank, Houston	56,933,000
merged on January 31, 1999 under the title of Union Planters Bank, National Association, Memphis (013349)	30,068,279,000
First Citizens National Bank, Dyersburg (005263)	331,953,000
and The Bank of Troy, Troy	58,775,000
merged on February 15, 1999 under the title of First Citizens National Bank, Dyersburg (005263)	353,860,000
Union Planters Bank, National Association, Memphis (013349)	19,815,274,000
and Bank of LaPlace of St. John the Baptist Parish, Louisiana, LaPlace	65,943,000
merged on February 19, 1999 under the title of Union Planters Bank, National Association, Memphis (013349)	19,881,217,000
Union Planters Bank, National Association, Memphis (013349)	19,815,274,000
and Charter Bank, S.B., Sparta	367,565,000
merged on March 19, 1999 under the title of Union Planters Bank, National Association, Memphis (013349)	20,182,839,000
Texas	
Norwest Bank Texas, National Association, San Antonio (014208)	8,856,822,000
and First National Bank of Missouri City, Missouri City (017631)	91,644,000
merged on February 20, 1999 under the title of Norwest Bank Texas, National Association, San Antonio (014208)	8,948,466,000
The Frost National Bank, San Antonio (005179)	6,279,934,000
and Keller State Bank, Keller	71,462,000
merged on January 14, 1999 under the title of The Frost National Bank, San Antonio (005179)	6,344,302,000
The First National Bank in Cleburne, Cleburne (013107)	102,503,000
and Cleburne State Bank, Cleburne	82,734,000
merged on March 6, 1999 under the title of The First National Bank in Cleburne, Cleburne (013017)	184,507,000
First State Bank, National Association, Abilene (017614)	268,437,000
and Azle State Bank, Azle	100,583,000
merged on March 12, 1999 under the title of First State Bank, National Association, Abilene (017614)	368,959,000
Austin Bank, Texas National Association, Jacksonville (005581)	137,044,000
and Austin Bank, Rusk, Texas, Rusk	55,885,000
merged on March 15, 1999 under the title of Austin Bank, Texas National Association, Jacksonville (005581)	192,929,000
Norwest Bank Texas, National Association, San Antonio (014208)	8,948,466,000
and First Valley Bank, Harlingen	445,794,000
merged on March 20, 1999 under the title of Norwest Bank Texas, National Association, San Antonio (014208)	9,394,260,000
Wyoming	
First National Bank in Evanston, Evanston (014570)	78,963,000
and First National Bank—Kemmerer, Kemmerer (016543)	34,314,000
merged on March 22, 1999 under the title of First National Bank in Evanston, Evanston (014570)	113,277,000

Affiliated mergers—thrift (mergers consummated involving affiliated national banks and savings and loan associations), from January 1 to March 31, 1999

Title and location (charter number)	Total assets
Illinois	
The Pontiac National Bank, Pontiac (014260)	170,709,000
and Home Guaranty Bank, S.B., Piper City	16,274,000
merged on January 1, 1999 under the title of The Pontiac National Bank, Pontiac (014260)	185,401,000
North Carolina	
First Charter National Bank, Concord (003903)	848,829,000
and Home Federal Savings and Loan, Charlotte	996,476,000
merged on March 18, 1999 under the title of First Charter National Bank, Concord (003903)	1,837,599,000

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Tables are provided by the Economic Analysis Division and include data for nationally chartered, FDIC-insured commercial banks that file a quarter-end call report. Data for the current period are preliminary and subject to revision. Figures in the tables may not sum to totals because of rounding.

Assets, liabilities, and capital accounts of national banks
March 31, 1998 and March 31, 1999

(Dollar figures in millions)

	March 31, 1998	March 31, 1999	Change March 31, 1998–March 31, 1999 fully consolidated	
	Consolidated foreign and domestic	Consolidated foreign and domestic	Amount	Percent
Number of institutions	2,549	2,432	(117)	(4.59)
Total assets	$2,972,012	$3,141,344	$169,332	5.70
Cash and balances due from depositories	215,325	190,753	(24,572)	(11.41)
Non-interest-bearing balances, currency and coin	145,890	135,333	(10,557)	(7.24)
Interest bearing balances	69,435	55,420	(14,015)	(20.18)
Securities	479,681	527,414	47,733	9.95
Held-to-maturity securities, amortized cost	66,225	55,999	(10,226)	(15.44)
Available-for-sale securities, fair value	413,456	471,415	57,958	14.02
Federal funds sold and securities purchased	121,795	108,199	(13,596)	(11.16)
Net loans and leases	1,845,444	1,979,533	134,089	7.27
Total loans and leases	1,880,747	2,016,799	136,052	7.23
Loans and leases, gross	1,882,881	2,018,721	135,840	7.21
Less: Unearned income	2,134	1,922	(212)	(9.95)
Less: Reserve for losses	35,303	37,266	1,962	5.56
Assets held in trading account	97,307	88,564	(8,743)	(8.98)
Other real estate owned	2,061	1,824	(237)	(11.48)
Intangible assets	53,226	68,160	14,934	28.06
All other assets	157,174	176,897	19,723	12.55
Total liabilities and equity capital	2,972,012	3,141,344	169,332	5.70
Deposits in domestic offices	1,715,979	1,747,066	31,087	1.81
Deposits in foreign offices	316,109	354,293	38,184	12.08
Total deposits	2,032,088	2,101,359	69,272	3.41
Non-interest-bearing deposits	414,968	405,369	(9,599)	(2.31)
Interest-bearing deposits	1,617,119	1,695,990	78,871	4.88
Federal funds purchased and securities sold	251,126	260,761	9,635	3.84
Demand notes issued to U.S. Treasury	12,852	9,817	(3,035)	(23.62)
Other borrowed money	219,038	273,509	54,471	24.87
With remaining maturity of one year or less	143,888	168,453	24,565	17.07
With remaining maturity of more than one year	75,150	105,056	29,907	39.80
Trading liabilities less revaluation losses	19,239	13,855	(5,384)	(27.99)
Subordinated notes and debentures	46,751	53,966	7,215	15.43
All other liabilities	137,353	149,347	11,994	8.73
Trading liabilities revaluation losses	49,268	51,719	2,451	4.97
Other	88,085	97,627	9,542	10.83
Total equity capital	253,566	278,731	25,165	9.92
Perpetual preferred stock	501	471	(30)	(5.96)
Common stock	17,537	16,624	(913)	(5.21)
Surplus	128,353	142,945	14,593	11.37
Net undivided profits and capital reserves	108,101	119,746	11,645	10.77
Cumulative foreign currency translation adjustment	(926)	(1,055)	(129)	NM

NM indicates calculated percent change is not meaningful.

Quarterly income and expenses of national banks
First quarter 1998 and first quarter 1999
(Dollar figures in millions)

	First quarter 1998	First quarter 1999	Change First quarter 1998–first quarter 1999 fully consolidated	
	Consolidated foreign and domestic	Consolidated foreign and domestic	Amount	Percent
Number of institutions	2,549	2,432	(117)	(4.59)
Net income	$9,984	$10,535	$551	5.52
Net interest income	26,887	28,665	1,778	6.61
Total interest income	52,190	53,803	1,613	3.09
On loans	39,650	40,762	1,113	2.81
From lease financing receivables	1,454	1,864	410	28.19
On balances due from depositories	1,159	846	(313)	(27.01)
On securities	7,479	8,284	806	10.78
From assets held in trading account	831	668	(163)	(19.59)
On federal funds sold and securities repurchased	1,618	1,378	(239)	(14.79)
Less: Interest expense	25,304	25,138	(165)	(0.65)
On deposits	17,660	16,946	(714)	(4.04)
Of federal funds purchased and securities sold	3,207	3,041	(167)	(5.20)
On demand notes and other borrowed money*	3,651	4,304	653	17.89
On subordinated notes and debentures	785	848	63	7.98
Less: Provision for losses	3,182	4,080	897	28.20
Non-interest income	18,301	22,550	4,248	23.21
From fiduciary activities	2,136	2,295	159	7.46
Service charges on deposits	3,263	3,493	230	7.06
Trading revenue	1,152	1,541	389	33.77
From interest rate exposures	306	667	361	117.76
From foreign exchange exposures	735	718	(17)	(2.28)
From equity security and index exposures	92	129	37	NM
From commodity and other exposures	19	27	8	NM
Total other non-interest income	11,751	15,221	3,470	29.53
Gains/losses on securities	619	368	(251)	NM
Less: Non-interest expense	27,933	31,166	3,232	11.57
Salaries and employee benefits	10,955	12,239	1,283	11.71
Of premises and fixed assets	3,420	3,924	504	14.73
Other non-interest expense	13,558	15,003	1,445	10.66
Less: Taxes on income before extraordinary items	5,244	5,770	526	10.03
Income/loss from extraordinary items, net of income taxes	537	(32)	(569)	(105.92)
Memoranda:				
Net operating income	9,047	10,315	1,268	14.02
Income before taxes and extraordinary items	14,691	16,337	1,646	11.20
Income net of taxes before extraordinary items	9,447	10,567	1,120	11.85
Cash dividends declared	7,666	5,180	(2,486)	(32.43)
Net charge-offs to loan and lease reserve	3,185	3,691	506	15.87
Charge-offs to loan and lease reserve	4,165	4,649	484	11.63
Less: Recoveries credited to loan and lease reserve	980	959	(21)	(2.15)

* Includes mortgage indebtedness
NM indicates calculated percent change is not meaningful.

Year-to-date income and expenses of national banks
Through March 31, 1998 and through March 31, 1999
(Dollar figures in millions)

	March 31, 1998	March 31, 1999	Change March 31, 1998–March 31, 1999 fully consolidated	
	Consolidated foreign and domestic	Consolidated foreign and domestic	Amount	Percent
Number of institutions	2,549	2,432	(117)	(4.59)
Net income	$9,984	$10,535	$551	5.52
Net interest income	26,887	28,665	1,778	6.61
Total interest income	52,190	53,803	1,613	3.09
On loans	39,650	40,762	1,113	2.81
From lease financing receivables	1,454	1,864	410	28.19
On balances due from depositories	1,159	846	(313)	(27.01)
On securities	7,479	8,284	806	10.78
From assets held in trading account	831	668	(163)	(19.59)
On federal funds sold and securities repurchased	1,618	1,378	(239)	(14.79)
Less: Interest expense	25,304	25,138	(165)	(0.65)
On deposits	17,660	16,946	(714)	(4.04)
Of federal funds purchased and securities sold	3,207	3,041	(167)	(5.20)
On demand notes and other borrowed money*	3,651	4,304	653	17.89
On subordinated notes and debentures	785	848	63	7.98
Less: Provision for losses	3,182	4,080	897	28.20
Non-interest income	18,301	22,550	4,248	23.21
From fiduciary activities	2,136	2,295	159	7.46
Service charges on deposits	3,263	3,493	230	7.06
Trading revenue	1,152	1,541	389	33.77
From interest rate exposures	306	667	361	117.76
From foreign exchange exposures	735	718	(17)	(2.28)
From equity security and index exposures	92	129	37	40.49
From commodity and other exposures	19	27	8	42.36
Total other non-interest income	11,751	15,221	3,470	29.53
Gains/losses on securities	619	368	(251)	(40.54)
Less: Non-interest expense	27,933	31,166	3,232	11.57
Salaries and employee benefits	10,955	12,239	1,283	11.71
Of premises and fixed assets	3,420	3,924	504	14.73
Other non-interest expense	13,558	15,003	1,445	10.66
Less: Taxes on income before extraordinary items	5,244	5,770	526	10.03
Income/loss from extraordinary items, net of income taxes	537	(32)	(569)	NM
Memoranda:				
Net operating income	9,047	10,315	1,268	14.02
Income before taxes and extraordinary items	14,691	16,337	1,646	11.20
Income net of taxes before extraordinary items	9,447	10,567	1,120	11.85
Cash dividends declared	7,666	5,180	(2,486)	(32.43)
Net charge-offs to loan and lease reserve	3,185	3,691	506	15.87
Charge-offs to loan and lease reserve	4,165	4,649	484	11.63
Less: Recoveries credited to loan and lease reserve	980	959	(21)	(2.15)

* Includes mortgage indebtedness
NM indicates calculated percent change is not meaningful.

Assets of national banks by asset size
March 31, 1999
(Dollar figures in millions)

	All national banks	National banks: Less than $ 100 million	National banks: $ 100 million to $1 billion	National banks: $1 billion to $10 billion	National banks: Greater than $10 billion	Memoranda: All commercial banks
Number of institutions reporting	2,432	1,253	992	143	44	8,721
Total assets	$3,141,344	$62,507	$257,053	$443,664	$2,378,121	$5,409,723
Cash and balances due from	190,753	3,269	11,205	23,404	152,875	313,817
Securities	527,414	17,349	71,371	87,815	350,879	995,427
Federal funds sold and securities purchased	108,199	4,324	9,973	18,606	75,297	265,403
Net loans and leases	1,979,533	34,776	152,807	280,047	1,511,903	3,193,089
Total loans and leases	2,016,799	35,259	155,096	287,095	1,539,349	3,250,948
Loans and leases, gross	2,018,721	35,382	155,431	287,206	1,540,701	3,254,610
Less: Unearned income	1,922	123	335	111	1,353	3,663
Less: Reserve for losses	37,266	484	2,289	7,048	27,445	57,858
Assets held in trading account	88,564	8	216	1,064	87,276	268,427
Other real estate owned	1,824	70	242	191	1,321	3,136
Intangible assets	68,160	223	1,475	10,359	56,102	83,300
All other assets	295,180	4,265	9,785	17,864	263,266	438,048
Gross loans and leases by type:						
Loans secured by real estate	756,914	19,920	93,186	122,371	521,438	1,346,292
1–4 family residential mortgages	368,623	9,614	43,283	61,010	254,715	653,102
Home equity loans	65,167	398	3,786	8,606	52,376	95,589
Multifamily residential mortgages	24,476	431	3,051	4,987	16,007	45,434
Commercial RE loans	202,151	5,704	31,725	35,016	129,706	380,499
Construction RE loans	59,300	1,462	7,490	11,193	39,155	111,906
Farmland loans	10,990	2,309	3,826	1,372	3,484	29,573
RE loans from foreign offices	26,208	0	25	187	25,996	30,188
Commercial and industrial loans	601,782	6,153	28,131	58,391	509,107	921,734
Loans to individuals	364,844	5,045	24,329	88,580	246,891	548,536
Credit cards	157,436	237	4,548	55,100	97,551	207,891
Installment loans	207,408	4,808	19,781	33,480	149,340	340,645
All other loans and leases	295,180	4,265	9,785	17,864	263,266	438,048
Securities by type:						
U.S. Treasury securities	64,749	2,601	8,566	8,482	45,100	129,153
Mortgage-backed securities	261,632	3,935	23,460	47,204	187,033	455,688
Pass-through securities	175,234	2,655	15,146	30,907	126,526	291,192
Collateralized mortgage obligations	86,398	1,281	8,314	16,297	60,507	164,496
Other securities	201,032	10,813	39,344	32,129	118,746	410,586
Other U.S. government securities	76,162	7,214	23,310	17,990	27,647	187,958
State and local government securities	39,264	2,891	11,789	8,020	16,564	88,281
Other debt securities	66,660	362	2,534	2,769	60,994	101,826
Equity securities	18,947	345	1,711	3,350	13,541	32,521
Memoranda:						
Agricultural production loans	20,151	3,688	5,027	2,645	8,791	43,956
Pledged securities	264,099	5,591	29,464	40,393	188,650	468,269
Book value of securities	527,054	17,310	71,131	87,549	351,064	992,658
Available-for-sale securities	471,055	13,461	56,402	72,057	329,134	848,106
Held-to-maturity securities	55,999	3,849	14,729	15,491	21,930	144,551
Market value of securities	527,950	17,380	71,505	87,885	351,180	996,538
Available-for-sale securities	471,415	13,501	56,642	72,324	328,949	850,875
Held-to-maturity securities	56,535	3,879	14,864	15,561	22,231	145,663

Past-due and nonaccrual loans and leases of national banks by asset size
March 31, 1999
(Dollar figures in millions)

		National banks				Memoranda:
	All national banks	Less than $ 100 million	$ 100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	All commercial banks
Number of institutions reporting	2,432	1,253	992	143	44	8,721
Loans and leases past due 30–89 days	$23,949	$612	$2,141	$4,428	$16,767	$39,067
Loans secured by real estate	8,852	287	1,036	1,480	6,049	15,532
1–4 family residential mortgages	4,431	158	564	674	3,036	8,026
Home equity loans	490	3	28	74	385	753
Multifamily residential mortgages	447	2	24	34	387	620
Commercial RE loans	1,974	64	275	402	1,233	3,638
Construction RE loans	966	19	93	270	585	1,609
Farmland loans	166	41	51	27	47	481
RE loans from foreign offices	377	0	0	0	377	407
Commercial and industrial loans	5,107	216	554	788	3,549	8,797
Loans to individuals	8,315	107	478	1,917	5,813	12,150
Credit cards	3,706	5	156	1,259	2,286	5,006
Installment loans	4,609	102	322	658	3,527	7,144
All other loans and leases	1,675	3	73	243	1,356	2,588
Loans and leases past due 90+ days	6,684	135	440	1,627	4,482	10,057
Loans secured by real estate	1,666	60	185	289	1,132	2,909
1–4 family residential mortgages	1,058	27	96	175	760	1,721
Home equity loans	98	1	9	23	65	158
Multifamily residential mortgages	21	0	3	3	15	49
Commercial RE loans	290	12	47	57	175	565
Construction RE loans	141	5	15	26	95	256
Farmland loans	44	15	15	5	9	142
RE loans from foreign offices	14	0	0	0	14	18
Commercial and industrial loans	654	54	104	74	421	1,296
Loans to individuals	4,041	21	138	1,245	2,638	5,373
Credit cards	2,953	4	88	1,076	1,786	3,554
Installment loans	1,088	17	50	169	851	1,819
All other loans and leases	324	0	12	19	292	480
Nonaccrual loans and leases	13,560	259	930	1,280	11,091	22,169
Loans secured by real estate	5,352	118	457	623	4,154	8,895
1–4 family residential mortgages	1,988	44	188	262	1,493	3,537
Home equity loans	136	1	9	18	109	219
Multifamily residential mortgages	275	2	10	27	236	372
Commercial RE loans	1,651	39	177	252	1,183	2,931
Construction RE loans	408	5	31	48	323	745
Farmland loans	160	28	41	16	76	300
RE loans from foreign offices	734	0	0	0	733	791
Commercial and industrial loans	5,358	122	354	423	4,459	8,866
Loans to individuals	1,773	17	77	178	1,501	2,898
Credit cards	315	0	20	132	163	1,042
Installment loans	1,458	17	57	46	1,338	1,856
All other loans and leases	1,077	2	42	55	977	1,510

Liabilities of national banks by asset size
March 31, 1999
(Dollar figures in millions)

	All national banks	National banks: Less than $ 100 million	$ 100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	Memoranda: All commercial banks
Number of institutions reporting	2,432	1,253	992	143	44	8,721
Total liabilities and equity capital	$3,141,344	$62,507	$257,053	$443,664	$2,378,121	$5,409,723
Deposits in domestic offices	$1,747,066	$53,320	$209,618	$278,434	$1,205,695	$3,062,459
Deposits in foreign offices	354,293	0	499	5,467	348,327	574,726
Total deposits	2,101,359	53,320	210,117	283,901	1,554,022	3,637,185
Non-interest to earnings	405,369	8,273	32,796	53,036	311,264	667,305
Interest bearing	1,695,990	45,046	177,321	230,865	1,242,757	2,969,880
Other borrowed funds	557,941	1,651	19,380	94,988	441,922	936,300
Subordinated notes and debentures	53,966	3	142	4,807	49,014	73,360
All other liabilities	149,347	610	3,051	12,761	132,926	293,287
Equity capital	278,731	6,923	24,363	47,206	200,238	469,592
Total deposits by depositor:						
Individuals and corporations	1,887,727	48,436	191,840	263,050	1,384,400	3,248,552
U.S., state, and local governments	72,712	4,098	14,541	12,938	41,134	142,421
Depositories in the U.S.	58,035	419	2,240	5,346	50,031	82,582
Foreign banks and governments	69,284	1	175	986	68,121	137,146
Certified and official checks	10,254	366	1,320	1,553	7,015	17,930
All other foreign office deposits	3,349	0	0	28	3,321	8,554
Domestic deposits by depositor:						
Individuals and corporations	1,631,533	48,436	191,532	258,160	1,133,406	2,850,505
U.S., state, and local governments	72,712	4,098	14,541	12,938	41,134	142,421
Depositories in the U.S.	28,992	419	2,177	5,343	21,053	43,251
Foreign banks and governments	4,563	1	49	440	4,074	9,432
Certified and official checks	9,267	366	1,320	1,553	6,028	16,851
Foreign deposits by depositor:						
Individuals and corporations	256,194	0	309	4,890	250,994	398,047
Depositories in the U.S.	29,043	0	63	2	28,978	39,332
Foreign banks and governments	64,721	0	127	547	64,047	127,714
Certified and official checks	987	0	0	0	987	1,079
All other deposits	3,349	0	0	28	3,321	8,554
Deposits in domestic offices by type:						
Transaction deposits	403,002	16,176	54,340	59,934	272,553	693,573
Demand deposits	328,760	8,263	31,619	47,853	241,026	534,508
NOW accounts	72,980	7,737	22,319	11,905	31,020	156,318
Savings deposits	745,573	11,155	60,059	115,843	558,516	1,205,327
Money market deposit accounts	522,840	5,826	35,850	74,144	407,022	807,842
Other savings deposits	222,733	5,330	24,209	41,700	151,495	397,485
Time deposits	598,491	25,989	95,220	102,656	374,626	1,163,560
Small time deposits	394,654	18,831	65,769	67,825	242,229	741,140
Large time deposits	203,837	7,158	29,451	34,831	132,397	422,420

Off-balance-sheet items of national banks by asset size
March 31, 1999
(Dollar figures in millions)

	All national banks	National banks: Less than $ 100 million	National banks: $ 100 million to $1 billion	National banks: $1 billion to $10 billion	National banks: Greater than $10 billion	Memoranda: All commercial banks
Number of institutions reporting	2,432	1,253	992	143	44	8,721
Unused commitments	$2,787,695	$80,013	$259,703	$624,950	$1,823,029	$3,749,223
Home equity lines	88,475	342	4,068	10,813	73,253	123,788
Credit card lines	1,667,305	75,356	230,397	545,882	815,671	2,058,886
Commercial RE, construction and land	80,558	1,014	6,483	11,140	61,922	135,814
All other unused commitments	951,357	3,302	18,756	57,116	872,183	1,430,735
Letters of credit:						
Standby letters of credit	137,703	147	1,573	9,157	126,826	218,175
Financial letters of credit	109,792	97	950	7,372	101,373	179,621
Performance letters of credit	27,911	50	623	1,785	25,453	38,555
Commercial letters of credit	17,103	34	548	722	15,799	25,721
Securities borrowed and lent:						
Securities borrowed	14,248	26	425	3,879	9,918	24,495
Securities lent	55,299	1	1,121	5,566	48,610	373,946
Financial assets transferred with recourse:						
Mortgages—outstanding principal balance	21,074	128	175	5,481	15,290	39,495
Mortgages—amount of recourse exposure	4,343	62	160	539	3,582	8,731
All other—outstanding principal balance	228,345	1	801	82,314	145,229	267,404
All other—amount of recourse exposure	13,819	0	53	4,961	8,805	17,373
Spot foreign exchange contracts	261,909	0	2	93	261,814	536,154
Credit derivatives (notional value)						
Reporting bank is the guarantor	19,058	0	35	30	18,994	80,521
Reporting bank is the beneficiary	29,599	0	0	0	29,599	110,586
Derivative contracts (notional value)	10,720,818	76	3,060	57,885	10,659,797	32,662,264
Futures and forward contracts	4,003,056	28	99	6,230	3,996,698	10,358,048
Interest rate contracts	1,727,024	28	66	5,573	1,721,357	5,595,123
Foreign exchange contracts	2,225,147	0	33	657	2,224,456	4,647,892
All other futures and forwards	50,886	0	0	0	50,886	115,033
Option contracts	2,584,472	48	825	13,379	2,570,220	7,502,801
Interest rate contracts	1,927,472	48	821	13,378	1,913,226	5,642,140
Foreign exchange contracts	505,871	0	0	1	505,869	1,309,426
All other options	151,130	0	4	0	151,125	551,234
Swaps	4,084,633	0	2,101	38,246	4,044,286	14,610,308
Interest rate contracts	3,898,222	0	2,101	37,556	3,858,564	13,839,779
Foreign exchange contracts	159,828	0	0	667	159,161	696,523
All other swaps	26,584	0	0	22	26,561	74,006
Memoranda: Derivatives by purpose						
Contracts held for trading	9,719,911	28	50	6,858	9,712,976	31,027,530
Contracts not held for trading	952,250	48	2,976	50,997	898,229	1,443,628
Memoranda: Derivatives by position						
Held for trading—positive fair value	123,874	0	0	51	123,823	447,335
Held for trading—negative fair value	123,448	0	0	45	123,403	436,914
Not for trading—positive fair value	7,756	0	10	379	7,368	12,259
Not for trading—negative fair value	4,165	0	25	167	3,973	7,492

Quarterly income and expenses of national banks by asset size
First quarter 1999
(Dollar figures in millions)

	All national banks	National banks: Less than $ 100 million	National banks: $ 100 million to $1 billion	National banks: $1 billion to $10 billion	National banks: Greater than $10 billion	Memoranda: All commercial banks
Number of institutions reporting	2,432	1,253	992	143	44	8,721
Net income	$10,535	$206	$802	$2,318	$7,209	$17,973
Net interest income	28,665	627	2,583	4,910	20,544	47,388
Total interest income	53,803	1,111	4,583	8,361	39,748	90,254
On loans	40,762	799	3,383	6,679	29,902	65,845
From lease financing receivables	1,864	4	25	86	1,748	2,584
On balances due from depositories	846	12	25	51	759	1,581
On securities	8,284	242	1,023	1,297	5,722	14,960
From assets held in trading account	668	0	2	20	646	1,930
On fed. funds sold & securities repurchased	1,378	55	125	228	970	3,354
Less: Interest expense	25,138	484	2,000	3,450	19,204	42,866
On deposits	16,946	464	1,769	2,159	12,555	29,740
Of federal funds purchased & securities sold	3,041	6	102	528	2,405	5,225
On demand notes & other borrowed money*	4,304	15	127	690	3,473	6,714
On subordinated notes and debentures	848	0	3	73	771	1,187
Less: Provision for losses	4,080	29	211	1,017	2,823	5,414
Non-interest income	22,550	388	1,264	5,063	15,835	34,722
From fiduciary activities	2,295	3	233	289	1,770	4,782
Service charges on deposits	3,493	70	257	455	2,711	5,061
Trading revenue	1,541	2	1	42	1,495	3,593
From interest rate exposures	667	2	1	30	633	1,434
From foreign exchange exposures	718	0	1	2	715	1,624
From equity security and index exposures	129	0	0	7	122	290
From commodity and other exposures	27	0	0	3	24	245
Total other non-interest income	15,221	312	773	4,277	9,858	21,286
Gains/losses on securities	368	2	12	56	298	565
Less: Non-interest expense	31,166	714	2,478	5,344	22,630	49,633
Salaries and employee benefits	12,239	304	1,088	1,564	9,284	21,219
Of premises and fixed assets	3,924	78	301	483	3,062	6,368
Other non-interest expense	15,003	332	1,089	3,297	10,285	22,046
Less: Taxes on income before extraord. items	5,770	67	368	1,346	3,989	9,622
Income/loss from extraord. items, net of taxes	(32)	(0)	0	(6)	(26)	(33)
Memoranda:						
Net operating income	10,315	205	794	2,287	7,030	17,623
Income before taxes and extraordinary items	16,337	274	1,170	3,669	11,224	27,628
Income net of taxes before extraordinary items	10,567	206	802	2,324	7,234	18,006
Cash dividends declared	5,180	142	539	1,134	3,366	9,095
Net loan and lease losses	3,691	16	142	909	2,623	5,005
Charge-offs to loan and lease reserve	4,649	28	199	1,102	3,320	6,412
Less: Recoveries credited to loan & lease resv.	959	12	56	193	697	1,407

* Includes mortgage indebtedness

Year-to-date income and expenses of national banks by asset size
Through March 31, 1999

(Dollar figures in millions)

	All national banks	National banks: Less than $ 100 million	$ 100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	Memoranda: All commercial banks
Number of institutions reporting	2,432	1,253	992	143	44	8,721
Net income	$10,535	$206	$802	$2,318	$7,209	$17,973
Net interest income	28,665	627	2,583	4,910	20,544	47,388
Total interest income	53,803	1,111	4,583	8,361	39,748	90,254
On loans	40,762	799	3,383	6,679	29,902	65,845
From lease financing receivables	1,864	4	25	86	1,748	2,584
On balances due from depositories	846	12	25	51	759	1,581
On securities	8,284	242	1,023	1,297	5,722	14,960
From assets held in trading account	668	0	2	20	646	1,930
On fed. funds sold & securities repurchased	1,378	55	125	228	970	3,354
Less: Interest expense	25,138	484	2,000	3,450	19,204	42,866
On deposits	16,946	464	1,769	2,159	12,555	29,740
Of federal funds purchased & securities sold	3,041	6	102	528	2,405	5,225
On demand notes & other borrowed money*	4,304	15	127	690	3,473	6,714
On subordinated notes and debentures	848	0	3	73	771	1,187
Less: Provision for losses	4,080	29	211	1,017	2,823	5,414
Non-interest income	22,550	388	1,264	5,063	15,835	34,722
From fiduciary activities	2,295	3	233	289	1,770	4,782
Service charges on deposits	3,493	70	257	455	2,711	5,061
Trading revenue	1,541	2	1	42	1,495	3,593
From interest rate exposures	667	2	1	30	633	1,434
From foreign exchange exposures	718	0	1	2	715	1,624
From equity security and index exposures	129	0	0	7	122	290
From commodity and other exposures	27	0	0	3	24	245
Total other non-interest income	15,221	312	773	4,277	9,858	21,286
Gains/losses on securities	368	2	12	56	298	565
Less: Non-interest expense	31,166	714	2,478	5,344	22,630	49,633
Salaries and employee benefits	12,239	304	1,088	1,564	9,284	21,219
Of premises and fixed assets	3,924	78	301	483	3,062	6,368
Other non-interest expense	15,003	332	1,089	3,297	10,285	22,046
Less: Taxes on income before extraord. items	5,770	67	368	1,346	3,989	9,622
Income/loss from extraord. items, net of taxes	(32)	(0)	0	(6)	(26)	(33)
Memoranda:						
Net operating income	10,315	205	794	2,287	7,030	17,623
Income before taxes and extraordinary items	16,337	274	1,170	3,669	11,224	27,628
Income net of taxes before extraordinary items	10,567	206	802	2,324	7,234	18,006
Cash dividends declared	5,180	142	539	1,134	3,366	9,095
Net loan and lease losses	3,691	16	142	909	2,623	5,005
Charge-offs to loan and lease reserve	4,649	28	199	1,102	3,320	6,412
Less: Recoveries credited to loan & lease resv.	959	12	56	193	697	1,407

* Includes mortgage indebtedness

Quarterly net loan and lease losses of national banks by asset size
First quarter 1999
(Dollar figures in millions)

	All national banks	National banks: Less than $ 100 million	National banks: $ 100 million to $1 billion	National banks: $1 billion to $10 billion	National banks: Greater than $10 billion	Memoranda: All commercial banks
Number of institutions reporting	2,432	1,253	992	143	44	8,721
Net charge-offs to loan and lease reserve	$3,691	$16	$142	$909	$2,623	$5,005
Loans secured by real estate	140	2	6	21	112	172
1–4 family residential mortgages	80	0	4	19	57	115
Home equity loans	33	0	0	8	24	39
Multifamily residential mortgages	(0)	(0)	1	0	(1)	(2)
Commercial RE loans	8	1	1	(6)	12	2
Construction RE loans	4	0	0	0	4	7
Farmland loans	(0)	(0)	(1)	0	0	(0)
RE loans from foreign offices	16	0	0	(0)	16	11
Commercial and industrial loans	662	6	29	30	597	1,012
Loans to individuals	2,704	8	104	851	1,740	3,551
Credit cards	2,031	2	76	777	1,177	2,681
Installment loans	673	6	28	75	563	870
All other loans and leases	184	(0)	4	7	174	270
Charge-offs to loan and lease reserve	4,649	28	199	1,102	3,320	6,412
Loans secured by real estate	257	3	12	42	200	352
1–4 family residential mortgages	105	1	6	23	76	159
Home equity loans	45	0	1	11	33	53
Multifamily residential mortgages	2	0	1	0	1	3
Commercial RE loans	74	2	4	8	61	98
Construction RE loans	11	0	1	1	9	17
Farmland loans	2	0	0	0	1	4
RE loans from foreign offices	18	0	0	0	18	18
Commercial and industrial loans	822	12	43	53	714	1,300
Loans to individuals	3,320	13	139	993	2,174	4,396
Credit cards	2,347	3	93	880	1,371	3,128
Installment loans	973	10	46	114	804	1,268
All other loans and leases	251	0	5	13	232	363
Recoveries credited to loan and lease reserve	959	12	56	193	697	1,407
Loans secured by real estate	117	2	6	21	88	180
1–4 family residential mortgages	25	1	2	4	19	44
Home equity loans	12	0	0	2	9	14
Multifamily residential mortgages	2	0	0	0	2	5
Commercial RE loans	66	0	3	14	49	96
Construction RE loans	7	0	0	1	6	10
Farmland loans	2	0	1	0	1	4
RE loans from foreign offices	2	0	0	0	2	7
Commercial and industrial loans	159	5	14	23	117	289
Loans to individuals	616	5	35	142	434	846
Credit cards	316	1	18	103	194	448
Installment loans	300	4	17	39	240	398
All other loans and leases	67	0	1	7	58	93

Year-to-date net loan and lease losses of national banks by asset size
Through March 31, 1999

(Dollar figures in millions)

	All national banks	National banks: Less than $100 million	$100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	Memoranda: All commercial banks
Number of institutions reporting	2,432	1,253	992	143	44	8,721
Net charge-offs to loan and lease reserve	3,691	16	142	909	2,623	5,005
Loans secured by real estate	140	2	6	21	112	172
1–4 family residential mortgages	80	0	4	19	57	115
Home equity loans	33	0	0	8	24	39
Multifamily residential mortgages	(0)	(0)	1	0	(1)	(2)
Commercial RE loans	8	1	1	(6)	12	2
Construction RE loans	4	0	0	0	4	7
Farmland loans	(0)	(0)	(1)	0	0	(0)
RE loans from foreign offices	16	0	0	(0)	16	11
Commercial and industrial loans	662	6	29	30	597	1,012
Loans to individuals	2,704	8	104	851	1,740	3,551
Credit cards	2,031	2	76	777	1,177	2,681
Installment loans	673	6	28	75	563	870
All other loans and leases	184	(0)	4	7	174	270
Charge-offs to loan and lease reserve	4,649	28	199	1,102	3,320	6,412
Loans secured by real estate	257	3	12	42	200	352
1–4 family residential mortgages	105	1	6	23	76	159
Home equity loans	45	0	1	11	33	53
Multifamily residential mortgages	2	0	1	0	1	3
Commercial RE loans	74	2	4	8	61	98
Construction RE loans	11	0	1	1	9	17
Farmland loans	2	0	0	0	1	4
RE loans from foreign offices	18	0	0	0	18	18
Commercial and industrial loans	822	12	43	53	714	1,300
Loans to individuals	3,320	13	139	993	2,174	4,396
Credit cards	2,347	3	93	880	1,371	3,128
Installment loans	973	10	46	114	804	1,268
All other loans and leases	251	0	5	13	232	363
Recoveries credited to loan and lease reserve	959	12	56	193	697	1,407
Loans secured by real estate	117	2	6	21	88	180
1–4 family residential mortgages	25	1	2	4	19	44
Home equity loans	12	0	0	2	9	14
Multifamily residential mortgages	2	0	0	0	2	5
Commercial RE loans	66	0	3	14	49	96
Construction RE loans	7	0	0	1	6	10
Farmland loans	2	0	1	0	1	4
RE loans from foreign offices	2	0	0	0	2	7
Commercial and industrial loans	159	5	14	23	117	289
Loans to individuals	616	5	35	142	434	846
Credit cards	316	1	18	103	194	448
Installment loans	300	4	17	39	240	398
All other loans and leases	67	0	1	7	58	93

Number of national banks by state and asset size
March 31, 1999

	National banks					Memoranda:
	All national banks	Less than $ 100 million	$ 100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	All commercial banks
All institutions	2,432	1,253	992	143	44	8,721
Alabama	28	14	13	0	1	159
Alaska	3	1	0	2	0	6
Arizona	15	5	5	4	1	43
Arkansas	52	18	33	1	0	202
California	92	40	44	5	3	334
Colorado	62	43	16	2	1	193
Connecticut	8	3	5	0	0	26
Delaware	16	3	6	4	3	33
District of Columbia	5	2	3	0	0	6
Florida	84	34	37	13	0	254
Georgia	64	28	34	2	0	340
Hawaii	1	0	1	0	0	11
Idaho	1	0	1	0	0	17
Illinois	218	99	105	11	3	738
Indiana	38	10	22	5	1	170
Iowa	49	30	17	2	0	441
Kansas	112	83	28	1	0	394
Kentucky	61	31	26	3	1	261
Louisiana	20	12	5	1	2	154
Maine	5	1	4	0	0	16
Maryland	17	4	11	2	0	79
Massachusetts	12	4	6	1	1	44
Michigan	36	17	17	1	1	168
Minnesota	137	84	46	5	2	507
Mississippi	20	7	12	1	0	99
Missouri	50	26	19	4	1	380
Montana	18	14	2	2	0	88
Nebraska	94	69	22	3	0	312
Nevada	8	2	2	4	0	27
New Hampshire	6	1	4	1	0	19
New Jersey	26	2	17	6	1	73
New Mexico	20	6	11	3	0	55
New York	64	19	37	6	2	154
North Carolina	10	2	3	2	3	69
North Dakota	18	9	7	2	0	114
Ohio	93	45	36	7	5	217
Oklahoma	115	77	35	3	0	305
Oregon	4	1	3	0	0	42
Pennsylvania	97	27	62	5	3	192
Rhode Island	2	0	0	1	1	7
South Carolina	20	13	6	1	0	77
South Dakota	23	12	9	1	1	104
Tennessee	34	9	18	4	3	202
Texas	400	262	128	7	3	786
Utah	8	3	2	2	1	50
Vermont	11	4	6	1	0	21
Virginia	30	7	21	2	0	149
Washington	17	14	3	0	0	80
West Virginia	30	14	11	5	0	91
Wisconsin	58	30	25	3	0	343
Wyoming	20	12	6	2	0	51
U.S. territories	0	0	0	0	0	18

Total assets of national banks by state and asset size
March 31, 1999
(Dollar figures in millions)

	National banks					Memoranda:
	All national banks	Less than $ 100 million	$ 100 million to $1 billion	$1 billion to $10 billion	Greater than $10 billion	All commercial banks
All institutions	$3,141,344	$62,507	$257,053	$443,664	$2,378,121	$5,409,723
Alabama	43,016	887	3,196	0	38,933	142,379
Alaska	4,351	54	0	4,297	0	5,063
Arizona	37,036	77	1,814	14,619	20,525	41,130
Arkansas	10,767	1,054	7,932	1,781	0	25,423
California	399,622	1,907	13,187	15,565	368,963	514,866
Colorado	20,760	1,990	3,506	5,018	10,246	37,421
Connecticut	1,010	163	846	0	0	3,811
Delaware	91,517	170	1,440	20,050	69,857	126,361
District of Columbia	473	51	422	0	0	576
Florida	42,377	2,146	9,725	30,506	0	80,495
Georgia	21,929	1,380	9,820	10,729	0	76,944
Hawaii	308	0	308	0	0	23,995
Idaho	204	0	204	0	0	1,841
Illinois	181,931	5,028	25,843	39,284	111,775	290,192
Indiana	43,557	482	8,971	21,132	12,973	67,883
Iowa	14,151	1,605	3,933	8,613	0	45,890
Kansas	13,632	3,709	7,952	1,971	0	33,929
Kentucky	25,933	1,966	4,732	8,577	10,657	52,366
Louisiana	34,754	654	1,072	5,218	27,809	49,285
Maine	1,221	36	1,185	0	0	4,816
Maryland	5,760	277	2,910	2,573	0	44,498
Massachusetts	72,623	215	1,119	1,030	70,259	141,466
Michigan	17,533	896	3,734	2,400	10,503	116,091
Minnesota	124,618	3,815	10,471	10,853	99,480	144,965
Mississippi	9,452	268	2,664	6,520	0	27,931
Missouri	45,541	1,248	5,306	16,408	22,581	78,894
Montana	3,433	544	299	2,589	0	9,645
Nebraska	15,722	3,054	4,910	7,759	0	27,300
Nevada	16,214	107	301	15,805	0	25,716
New Hampshire	8,702	41	954	7,707	0	17,108
New Jersey	50,441	31	6,338	17,008	27,063	100,074
New Mexico	11,801	267	3,589	7,945	0	15,720
New York	375,123	1,338	11,696	11,077	351,013	1,149,962
North Carolina	591,771	56	884	3,014	587,817	655,682
North Dakota	5,863	395	2,305	3,162	0	10,837
Ohio	215,994	2,254	12,075	24,237	177,428	265,390
Oklahoma	20,261	3,826	6,418	10,017	0	35,529
Oregon	482	4	478	0	0	6,349
Pennsylvania	154,902	1,487	18,118	13,066	122,231	194,297
Rhode Island	83,614	0	0	5,462	78,152	91,529
South Carolina	3,653	569	1,576	1,507	0	19,126
South Dakota	22,918	443	2,735	5,458	14,282	29,868
Tennessee	85,911	597	4,585	13,303	67,426	105,210
Texas	127,974	12,801	29,061	25,092	61,019	176,873
Utah	25,019	207	315	7,369	17,128	44,987
Vermont	3,617	256	1,551	1,810	0	7,488
Virginia	11,367	344	4,678	6,344	0	74,942
Washington	1,391	625	767	0	0	12,363
West Virginia	13,812	869	2,957	9,986	0	23,850
Wisconsin	21,721	1,725	7,158	12,838	0	81,682
Wyoming	5,562	589	1,010	3,963	0	8,408
U.S. territories	0	0	0	0	0	41,278

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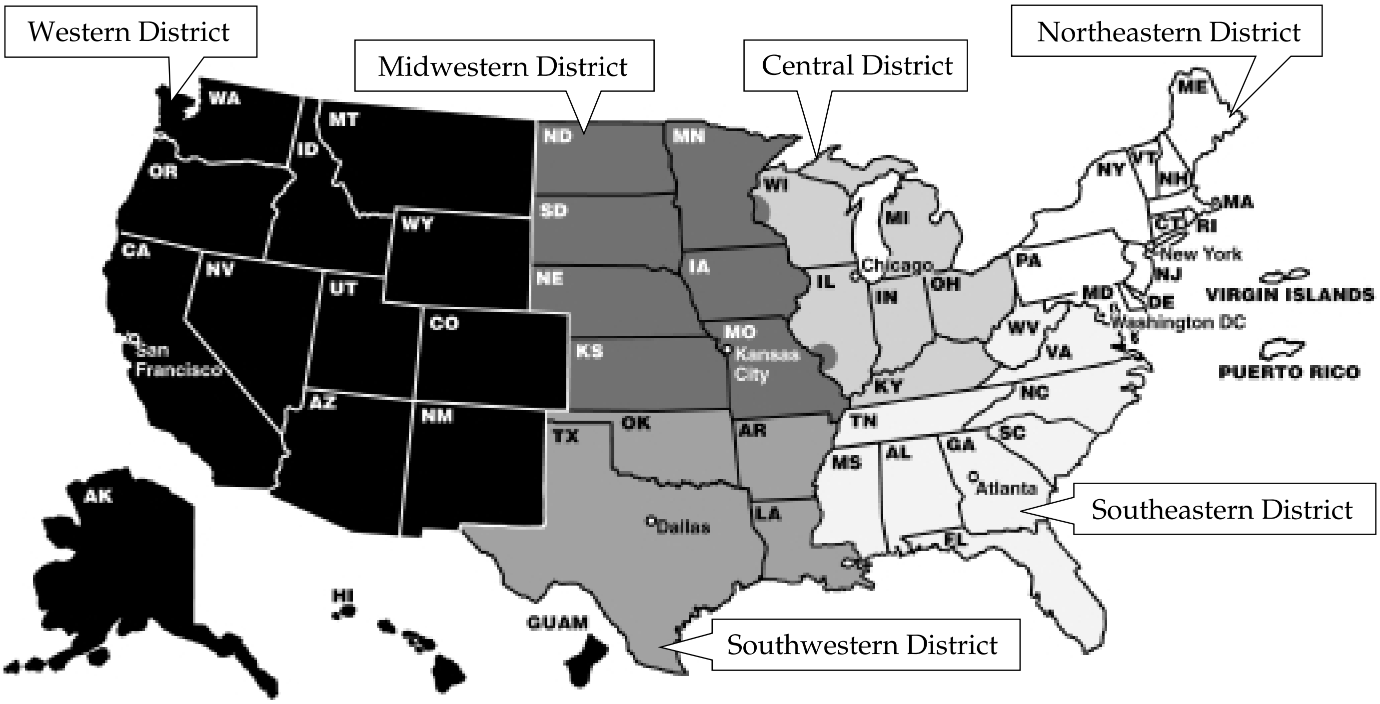

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